Microfinance in India: A New Regulatory Structure

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Institutions, investors, and microfinance customers are all requesting new regulation following the crisis in Andhra Pradesh. This paper will examine the current microfinance regulatory structure, pending regulation, and MFI response to the Reserve Bank of India released in May 2011. This study identifies of the current and pending regulation, and offers a perspective regarding the future the limitations of regulation

Introduction

The Indian microfinance sector witnessed tremendous growth over the last five years, during which institutions were subject to little regulation. Some microfinance institutions were subject to prudential requirements; however no regulation addressed lending practices, pricing, or operations. The combination of minimal regulation and rapid sector growth led to an environment where customers were increasingly dissatisfied with microfinance services, culminating in the Andhra Pradesh crisis in the fall of 2010.

Leading up to the Andhra Pradesh crisis, microfinance institutions were experiencing a large influx of equity and debt investment. Some institutions were doubling their size each year, aiming to reach more customers and serve more areas. As institutions scaled up quickly, hiring and training processes were less thorough, resulting in employees who engaged in inappropriate collection practices and lending models that led to customer over-indebtedness. In August 2010, SKS Microfinance held the first initial public offering (IPO) for a microfinance institution in India, raising USD 347 million[1] and drawing attention to the potential profits of the sector. Media reports took different viewpoints on the IPO, some celebrating the sector, and others characterizing the profits as taking advantage of the poor. Further reports cited links between Microfinance Institutions (MFIs) lending and suicides in Andhra Pradesh. The incident culminated when Andhra Pradesh's Chief Minister passed the Andhra Pradesh Microfinance

Ordinance 2010[2], which includes a number of measures that greatly restricts microfinance institutions' operations. As a result of the ordinance, and the general attitude towards microfinance in Andhra Pradesh, loan repayments dropped dramatically[3].

Due to low repayment rates, microfinance institutions, with exposure to Andhra Pradesh, suffered significant losses. Banks stopped lending to microfinance institutions all over India, for fear that a similar situation would occur elsewhere, resulting in a liquidity crunch for microfinance institutions, which are largely dependent on bank lending as a funding source. With the sector at a standstill, microfinance institutions, microfinance clients, banks, investors, and local governments were calling for new regulation to address the prominent issues of the sector. The Reserve Bank of India (RBI) responded by appointing an RBI sub-committee know as the Malegam Committee.

This committee aimed to address the primary customer complaints that led to the crisis, including coercive collection practices, usurious interest rates, and selling practices that resulted in over-indebtedness. The existing regulations did not address these issues, thus, who should respond to these issues, and how they should respond, was uncertain. This prolonged the general regulatory uncertainty and the resulting repayment and institutional liquidity issues.

The Malegam Committee released their recommended regulations in January 2011. These recommendations were 'broadly accepted' by RBI in May 2011, though specific regulation was only released regarding which institutions qualify for priority sector lending at this time. Additionally, an updated version of the Micro Finance Institutions (Development and Regulations) Bill 2011 is in Parliament, which aims to provide a regulatory structure for microfinance institutions operating as societies, trusts, and cooperatives. Although this shows that regulators are taking steps to address the crisis issues and resolve regulatory uncertainty, banks have not resumed lending to microfinance institutions as of July 2011.

In this paper, we will analyze the strengths and weaknesses of the current regulatory structure in India, including the pending Malegam Micro Finance Institutions (Development and Regulations) Bill 2011. We will perform a case study analysis regarding how microfinance institutions are viewing and implementing the new RBI regulation, and conclude by offering a perspective regarding the future of microfinance regulation in India.

Existing Regulatory Framework

The current regulatory structure currently consists of the regulation prior to the Andhra Pradesh crisis, various state legislations, and the partial implementation of the Malegam Report by RBI. This section will also include recent proposed legislation, including items from the Malegam Report that have not yet been addressed by RBI and the Micro Finance Institutions (Development and Regulations) Bill 2011.

Legal Structure

A microfinance institution acquires permission to lend through registration. Each legal structure has different formation requirements and privileges. Microfinance institutions in India are registered as one of the following five entities:

- Non Government Organizations engaged in microfinance (NGO-MFIs), comprised of Societies and Trusts
- Cooperatives registered under the conventional state-level cooperative acts, the national level multi-state cooperative legislation Act (MSCA 2002), or under the new state-level mutually aided cooperative acts (MACS Act)
- Section 25 Companies (not-for-profit)
- For-profit Non-Banking Financial Companies (NBFCs)
- NBFC-MFIs

NGO-MFIs, Cooperatives, and Section 25 Companies

Microfinance institutions operating as a non-profit company operate as either an NGO-MFI, Cooperative, or Section 25. Each is structured slightly differently in terms of ability to accept equity investments and dividends. There exists little regulation that applies to these structures, aside from registration requirements.

NBFCs

The mainstream financial sector in India is divided primarily into two categories, banks and NBFCs. Banks adhere to much more stringent regulation than NBFCs because they are permitted to accept public deposits and are considered to possess systemic risk. The NBFC encompasses many different types of financial companies, which are all subject to the same regulatory requirements. Many microfinance institutions have recently registered as NBFCs to take advantage of access to capital markets. Microfinance institutions operating as NBFCs account for the great majority of the microfinance market in India, with about 50 NBFCs responsible for 80 percent of all microfinance loans (by outstanding portfolio)[4].

NBFC-MFIs

For-profit institutions that qualify for priority sector lending funds are registered as NBFC-MFIs. This NBFC sub-category was created by RBI in May 2011 as a way to classify NBFCs operating as microfinance institutions which meet certain requirements. Currently, it is unclear how many NBFCs will elect to register as NBFC-MFIs, and how many will continue to operate as NBFCs.

Current Regulation

Very little regulation exists for NGO-MFIs and Cooperatives, aside from registration with a local or state authority. Currently there is no regulator that oversees NGO-MFIs, Cooperatives, and Section 25s. RBI is the regulator for NBFCs. NBFCs are subject to some prudential regulation, including a minimum capital requirement, a capital adequacy requirement, and foreign investment restrictions. Since NBFCs encompass many types of financial institutions, microfinance institutions operating as NBFCs are subject to no specific regulation relating to lending, pricing, or operations.

Recent regulatory discussion surrounds the partial acceptance of the Malegam Report by RBI in May 2011, where RBI created the NBFC-MFI designation. RBI stated that it 'broadly accepts the Malegam Committee recommendations', although specific regulation was released only to determine which institutions qualify for priority sector lending. The new regulation from RBI, currently, only applies to the newly created NBFC-MFI category. Microfinance institutions operating under other legal structures face minimal regulatory requirements, aside from registration, though recent drafts of the pending Micro Finance Institutions (Development and Regulations) Bill 2011, has put all microfinance institutions under the jurisdiction of RBI.

There has been dramatic change in the regulation of microfinance institutions recently, with much more change expected to follow in the coming months. We will discuss major regulatory points, including priority sector lending, deposit mobilization, access to capital, the Money Lending Act, and state level regulation. We will also discuss pending regulation, including portions of the Malegam Report which have not been specified by RBI, and the Micro Finance Institutions (Development and Regulations) Bill 2011.

Priority Sector Lending

Priority sector lending is a government initiative which requires banks to allocate a percentage of their portfolios to investment in specified priority sectors at a reduced interest rate. Currently only microfinance institutions registered as NBFC-MFIs are designated as a priority sector. The number of priority sectors has recently been reduced, which suggests that banks will rely more heavily on lending to microfinance institutions to meet the priority sector requirements. In order to register as a NBFC-MFI, an institution must meet requirements specified by RBI[5].

RBI requires that a minimum of 75% of a NBFC-MFI's loan portfolio must have been originated for income-generating activities. Additionally, an NBFC-MFI must have 85% of its total assets as qualifying assets (excluding cash, balances with banks and financial institutions, government securities and money market instruments). A qualifying asset is a loan which meets the following criteria:

- Borrower's household annual income does not exceed Rs. 60,000 or Rs. 1,20,000 for rural and urban areas respectively
- Maximum loan size of Rs. 35,000 (first cycle) and Rs. 50,000 (subsequent cycles)
- Maximum borrower total indebtedness of Rs. 50,000
- Minimum tenure of 24 months when loan exceeds Rs. 15,000
- No prepayment penalties
- No collateral
- Repayable by weekly, fortnightly or monthly installments, at the choice of the borrower

An NBFC-MFI must also adhere to the following pricing requirements:

- Margin cap of 12%
- Interest rate cap of 26%
- Only three pricing components
    - Interest rate
    - Processing fee (maximum 1%)
    - Insurance premium

- No penalty for delayed payment
- No security deposit or margin can be taken

Banks are responsible for ensuring that the institutions receiving priority sector funds adhere to these requirements, with verification through a quarterly Chartered Accountant's Certificate. Securitized assets may also qualify as priority sector assets if an institution meets these requirements. We assume that NBFC-MFIs must also adhere to general NBFC requirements.

Accepting Deposits

Current regulation stipulates that only NBFCs and Cooperatives are permitted to accept deposits, though NBFCs must adhere to additional stringent regulations[6] and Cooperatives are only permitted to accept deposits from their members, not the general public. The deposits limit for NBFCs is linked to the size of an institution's Net Owned Fund (NOF). No microfinance institution registered as an NBFC, currently accepts deposits because regulation requires that institutions must obtain an investment grade rating, which no microfinance institution has obtained. Uncollateralized loans are considered more risky by rating agencies, making it unlikely that microfinance institutions, utilizing joint-liability groups as collateral, or not requiring collateral at all, will be able to attain an investment grade rating. The Malegam Committee made no recommendations regarding deposit-taking, thus RBI is not expected to address this issue for NBFC-MFIs in the near future.

Financing Restrictions

Access to capital is determined primarily by an institution's registration status. Some registration entities are better suited to access traditional financing, such as bank lending, equity, and more sophisticated financial products, while others obtain funds through donations, grants, or members.

NBFCs can receive both equity and debt investments. NBFCs can raise foreign equity investment, though a minimum investment USD 500,000 restriction applies, which cannot result in more than a 51% stake in the institution. Grants and subsidized on-lending funds from domestic and foreign sources are not restricted provided that the foreign grants should not exceed the ceiling of USD 5 million per year. RBI regulates NBFCs that are not listed on a public stock exchange. RBI's Foreign Investment Promotion Board (FIPB) has mandated the following foreign direct investment (FDI) for NBFCs:

- Maximum 51% FDI for companies with capitalization USD 500,000 or less
- Maximum 75% FDI for companies with capitalization USD 500,000 - 5 million
- No maximum FDI for companies with capitalization greater than USD 50 million

Investors of foreign origin fall under the above restrictions for foreign capital, even if channeled through local semi-independent funds. Two of the main sources for domestic capital are currently SIDBI and NABARD, and emerging local microfinance focused funds such as Bellwether Microfinance Fund and Aavishkaar Goodwell[7]. NBFCs are also the only entities that attract more sophisticated financial options, such as securitization or non-convertible debentures, where additional RBI guidelines apply. RBI has not addressed any investment regulation regarding NBFC-MFIs, so at this point we presume that these institutions must adhere to the same requirements as NBFCs.

Section 25 companies have difficulty attracting equity investments because they are unable to offer dividends and exit opportunities are difficult to predict. They can access External Commercial Borrowing (ECB) up to USD 5 million, though many Section 25s end up borrowing significantly less than the USD 5 million limit, due to leverage limitations. Other MFI forms cannot accept equity investments.

Microfinance Institution Self-Regulation

Microfinance institutions in India often voluntarily join an industry association, which acts as a commitment and guide for self-regulation. Microfinance industry associations have been developed to better discussion with policy makers, improve capacity building, and identify minimum standards of performance through institutional collaboration and commitment. An industry association will identify a code of conduct for its members, which will focus on fair practices with borrowers and among member organizations. This code of conduct will address lending methods, collection practices, institutional transparency, and training practices for member institutions. Often institutions will be required to develop their own code of conduct as well, which more specifically addresses how the institution will uphold the fair practices outlined by the industry association. Currently, the two biggest industry associations in India are the Microfinance Institutions Network (MFIN) and Sa-dhan. Both of these associations offer a great deal of resources, guidance, and forums for institution discussion so that the most pressing issues facing the industry can be collectively addressed.

State Level Regulation

Various requirements have been enacted to restrict and control microfinance practices at the state level. The most prominent state level regulations are the Money Lending Act and the Andhra Pradesh Micro Finance Institutions (regulation of money lending) Ordinance, 2010. The Money Lending Act, though originally intended to restrict the interest rates charged by money lenders, has been applied to microfinance institutions in some states. The Andhra Pradesh Ordinance was enacted in 2010 during the repayment crisis in Andhra Pradesh (AP), greatly restricting microfinance institution operations by including measures such as district by district registration, required collection near local government premises, and forced monthly repayment schedules.

Pending Regulation: The Malegam Report

RBI broadly accepted the Malegam Report[8] and specified regulation detailing the requirements and institution must meet to qualify for priority sector lending. RBI has stated that it will release more regulation in the coming months. Some of the new regulation for priority sector lending is exactly the same or very similar to the Malegam Report recommendations, while other parts of the regulation are entirely different than the committee recommendations. As a result, predicting the specifics of the new regulation is difficult, so below we have highlighted the drawbacks of major sections of the Malegam Report that have yet to be addressed.

Over-Indebtedness

A set of recommendations aims to enforce maximum indebtedness levels without the use of a customer credit information system. These include:

- MFIs can only lend to members of a Joint Liability Group (JLG)
- A borrower cannot be a member of more than one SHG/JLG
- Not more than two MFIs can lend to one borrower

All of these limits restrict the choices of consumers. A consumer has the best knowledge of how much credit is he requires and how much he can repay. Though there is more individual risk, individuals will have more opportunities to meet their financial needs without these restrictions. If this loan limit is imposed, the unmet demand from formal sources might force the consumers to borrow from money lenders and other informal sources with more severe consequences. Additionally, implementation of these requirements will be difficult since currently customers report their own indebtedness. Until a credit reference system is put in place, it will be impossible to accurately gauge household total indebtedness.

Documentation and Transparency

Documentation recommendations intend to increase transparency of product costs and risks, so that consumers are better informed to make decisions and compare products to those offered by other institutions. These include:

- MFIs must provide borrowers a loan card which shows the effective rate of interest, other terms and conditions of the loan, information which adequately identifies the borrower, and acknowledgements of payments received
- Effective rate of interest must be displayed in all offices, all literature, and on website
- Standard loan agreement

These measures do increase product transparency and could greatly benefit the decision process of the consumer. The only concern is that when implemented, these requirements could potentially burden and slow the lending process, or provide too much information for less financially literate clients to interpret.

Collection Practices

Collection practice restrictions aim to stop coercive and abusive collection techniques, which were a major complaint of consumers leading up to the AP crisis. These include:

- Sanctioning and disbursement of loans should be done only at a central location
- Field staff should not be allowed to make recovery at customer's place of residence or place of work
- All recoveries should be made at the group level
- More than one individual should be involved in sanctioning and disbursement
- Disbursement should be closely supervised
- MFIs and their management teams should be subject to severe penalties if coercive methods of recovery are used

- Regulators should monitor systems for recruitment, training, and supervision of field staff

Although these restrictions would reduce coercive and abusive collection techniques, they greatly restrict the operations of microfinance institutions, and may deter some lending methodologies that offer greater convenience to the customer. The restrictions also do not allow for individual lending, which could be a beneficial product offering for customers. The best way to protect consumers from MFI collection malpractices is to have a well-functioning complaint redressal procedure, so that if inappropriate actions occur, the regulator and the institution can respond appropriately[9].

Credit Information Bureau

- One or more Credit Information Bureaus should be established and operational as soon as possible
- All MFIs should be required to become members of a bureau
- MFIs are responsible for obtaining information from potential borrowers until bureau is functional

The recommendations of the Malegam Committee focus on the important limitations of existing regulation. However, further amendments based on research and policy discussions must be made so that the regulatory framework optimizes the short and long term benefits to consumers and institutions.

Pending Regulation: Micro Finance Institutions (Development and Regulations) Bill 2011

The Micro Finance Institutions (Development and Regulations) Bill 2011[10] is an updated version of an earlier bill drafted in 2007. The bill has been re-drafted several times, with the most recent draft released in July 2011 to consider the most recent RBI regulation. The bill addresses all legal forms of microfinance institutions, providing a comprehensive legislation for the sector. New regulation includes:

- Designation of RBI as the sole regulator for all microfinance institutions,
    - Power to regulate interest rate caps, margin caps, and prudential norms
    - All microfinance institutions must register with RBI

- Formation of a Micro Finance Development Council, which will advise the central government on a variety of issues relating to microfinance
- Formation of State Advisory Councils to oversee microfinance at the state level
- Creation of Micro Finance Development Fund for investment, training, capacity building, and other expenditures as determined by RBI

The designation of RBI as the sole regulator would be a positive step forward for the sector. Though the specifics of regulation are yet to be determined, having one respected regulatory who is acknowledged as in charge of all aspects of the sector would lead to a great reduction of regulatory uncertainty. If the bill passes, a greater challenge will remain; RBI must effectively regulate and monitor a great number of microfinance institutions that have previously been subject to very little regulation.

Current Regulation Limitations

Much of the new regulation following the Malegam Committee's proposals will be released in the coming months, so we will refrain from further commenting on the current lack of regulation relating to certain issues that will certainly be addressed. Rather, we will focus our analysis on the limitations of the regulatory structure to problems with enacted regulation and issues that we suspect that RBI will not address, specifically the lack of clarity regarding central and state regulatory jurisdiction, implementation of priority sector lending qualification, the margin and interest rate caps, institution funding restrictions, and the inability of institutions to take public deposits.

State vs. Central Regulatory Jurisdiction Uncertainty

A major limitation of the current regulation is the lack of clarity regarding central and state regulatory jurisdiction. During late 2010 and early 2011, both Andhra Pradesh and Gujarat passed legislation barring specific microfinance practices within the state, requiring specific consumer protection policies and capping interest rates. States currently have great discretionary power as to how to interpret the Money Lending Act. Stability and confidence will elude the sector until this regulatory ambiguity is resolved.

Implementation of Priority Sector Lending Qualification

A second limitation is the implementation of the new RBI requirements regarding priority sector lending, particularly with regard to borrower income and borrower indebtedness. Since there are no tax filings or credit reports for the majority of microfinance customers, this information is often reported by the customer. Thus, customers have incentive to misrepresent their income and indebtedness in order to qualify for a loan. Without a functioning credit bureau, these customer characteristics requirements are impossible to accurately enforce.

Margin and Interest Rate Cap

Another limitation is a universal margin and interest rate cap could be detrimental for the sector, since it would most likely result in the reduction of financial services in various areas and populations where returns would not justify the operating costs. An interest rate cap should take into account various factors that typically affect the cost of operation, such as area of operation, average loan amount, legal form, and size of the microfinance institution. When interest rate caps have been implemented on microfinance services in other countries, microfinance institutions have pulled out of rural areas, stopped serving the poorest of the poor, increased the average loan size, and have had difficulty remaining solvent[11].

Lack of Funding Diversification

Lack of diversification of funding is also problematic for microfinance institutions due to current regulation regarding access to capital. Microfinance institutions are highly dependent on lending from Indian banks, which was problematic when all of the banks stopped finding microfinance institutions to be credit-worthy during the AP crisis. Though microfinance institutions may diversify lending amongst Indian banks, these banks tend to view the microfinance sector very similarly, resulting in a lack of diversification benefits.

Finally, allowing microfinance institutions to accept public deposits would add a source of funding diversification and benefit the customer. Customers may be able to better smooth consumption and resist the temptation to spend if they have access to a savings product. Regulation should permit institutions that meet reasonable prudential qualifications to accept public deposits. An alternative to the current system would be to base the strength of a microfinance institution on ratings that come from agencies or methods that specialize in the unique microfinance lending methodology[12].

MFI Response to New RBI Regulation

The Centre for Microfinance interviewed over 30 MFIs in the summer of 2011[i], asking them about their response to the recent regulation and their perspectives on the sector in general. In this section, we will generally review the responses, and look at three institutions' responses to highlight some individual issues arising as a result of new regulation.

Overview

Overall, the surveyed MFIs reported that national regulation has been needed for a long time. They feel that the new RBI regulations are not clear or well communicated, and the banks that previously acted as sources of funding are more cautious and selective in offering financial support. However, MFIs felt the RBI regulation could protect MFIs against the implementation of restrictive state legislation.

One of the primary concerns expressed by the interviewed MFIs involved how equitable the new regulations will be for institutions of different sizes. A Section 25 organization stated that the uniform policy would be more difficult for smaller MFIs to adapt and adhere to if applied to all, resulting in smaller institutions being pushed out of the market by more flexible larger organizations. There is also question over how difficult it will be for new start-up microfinance organizations to meet the demands of the market.

Several MFIs have also expressed concern over the requirement that a minimum of NBFC-MFI's loan portfolio must be used for income-generating activities. Several MFIs have recognized that a large proportion of clients use loans for consumption, rather than productive purposes.

The MFIs responded with mixed opinions in regard to the interest rate and margin cap. While several of the institutions described the margin as reasonable, one MFI reported that these new restrictions on margins and interest rates are too stringent, and they will limit product innovation. Additionally, operating costs vary across regions, and these caps may not be high

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[i] Interviews were conducted by members of the the Microfinance Researchers Alliance Program (MRAP): Deepti KC and Indrany Roy Chowdhury

enough to support initiatives in remote areas. Another institution stated that the margin cap would act as an incentive for MFIs to scale up at a greater rate.

One aspect of the regulation to which all MFIs responded positively was recommendation for the creation of a credit bureau and the mandatory membership of all MFIs. Currently, an appraisal of a client's credit-worthiness is expensive, timely, and often inaccurate. Many MFIs felt a credit bureau could act as a more accurate tool for reviewing indebtedness and repayment history.

To highlight some of the general issues identified by the survey, we will discuss the specific reactions of three microfinance institutions, Village Financial Services, Arohan Financial Services, and Trident Microfinance.

Village Financial Services Ltd.

Village Financial Services has operated as an NBFC since 2006. The institution focuses its services in West Bengal and Bihar, reaching 2,22,357 clients. Clients are limited to women, who have a maximum monthly income of Rs. 4000 in rural areas and Rs. 5000 in urban areas. The institution uses a joint lending model.

Since the introduction of the Malegam Committee Recommendations, Village Financial Services reports that repayment has dropped from 99% to 96-97%. The NBFC attributes these changes to clients' growing uncertainty about the microfinance sector. Borrowers are delaying their last repayment installments because they lack assurance that they will have continued access to new loans.

Furthermore, the institution says that it is currently waiting for bank funding, and loans are being dispersed to clients on a highly selective basis. Clients are receiving false hope and are subjected to extensive waiting periods. The representative from Village Financial Services notes that larger MFIs have additional funding sources, so they are able to better withstand the delay in bank funding. However, smaller regional MFIs are experiencing the impact more acutely.

Village Financial Services also expressed concern over the interest and margin caps, describing the measure as a negative step. The institution stated that in the past their funding costs were 10-11%, but their funding costs have increased to 14-15% in the recent months due to the RBI revisions of the base rate. The issue is further augmented by the lack of regulation on interest rates charged on priority sector lending by banks. In light of these challenges, the NBFC has stated that it is exploring other ways to minimize their costs.

Village Financial Services also expressed concern over the two-year loan tenure for loans over Rs. 15,000. The NBFC fears that the increase in loan tenure will result in dampened liquidity and increased risk. Additionally, the institution had apprehensions regarding verification of client income. In order to determine client income, Village Financial Services uses ration cards of prospective clients, as other methods are too expensive and timely. The NBFC noted that the RBI guidelines lack clarity over what will happen if a regular MFI client has an increase in income while availing micro-financial services.

Arohan Financial Services Pvt. Ltd.

Arohan Financial Services Pvt. Ltd. is a NFBC operating in 23 districts across West Bengal, Assam, and Bihar. The institution has been in service since 2006, currently serving 2,14,059 clients. Arohan uses a joint lending group model, and it has Rs. 9 crore in outstanding loans as of March 2011.

A representative from Arohan reports that the institution is concerned over the lack of regulation regarding an interest rate cap on how much MFIs can be charged by banks. The representative stated that there are likely to be cases in which banks charge 14% interest rates, thus reducing the profit margin for MFIs. This will create an environment that unsustainable for MFIs.

Yet, Arohan reports that in the long run, the new RBI regulations will give banks greater confidence in the microfinance sector, but that banks are not ready to begin funding. The representative from Arohan stated that banks do not feel compelled to lend to MFIs because they are not a 'big ticket.' The representative predicts that in the future, an MFI's overall performance, credibility, accountability, and personal relations will be the determinants of available funding opportunities.

The representative of Arohan explained that the institution is currently experiencing a shortage of funds, which is affecting timely loan disbursals to clients. He explains, "Borrowers don't understand. Who is RBI? What is regulation? They are losing confidence in us. This is bad for the sector." Overall, however, the representative was optimistic that the negative consequences of the new regulations will only be short-term.

Trident Microfinance

Trident Microfinance is a Non-Banking Financial Company (NBFC), which has been operating in Andhra Pradesh, Madhya Pradesh, and Uttar Pradesh since 2007. Trident utilizes a joint lending group operational model to serve 2,54,000 clients. As of the end of March 2011, the NBFC had Rs. 150 crore in outstanding loans.

A representative from Trident reported that overall the institution believes that the Malegam Committee's recommendations are a positive addition to the microfinance sector. However, Trident has had to take certain steps to ensure the survival of the institution following the AP crisis and subsequent Committee recommendations, such as the laying off of staff and closing down MFI branches. As of the end of September 2010, Trident had 109 branches, which has since been reduced to 84. Currently, the institution is in the process of further reducing the number of branches to around 50. Branches were primarily eliminated from urban areas, particularly in Hyderabad.

The representative from Trident Microfinance expressed concern over several of the RBI regulatory changes. The representative reported that the 26% interest rate cap was 'not encouraging,' and Trident's clients had rarely reported problems with the interest rate in the past. However, as of present, it appears unlikely that the interest rate cap will affect the institution. Trident Microfinance also believes that the 12% margin cap proposed by RBI is unreasonable, and it should be removed from the recommendations.

In response to the new RBI rule that borrowers' indebtedness cannot exceed Rs. 50,000, Trident stated that it would be likely that borrowers could easily misstate details regarding their debt. However, the institution expressed faith that a microfinance credit bureau would be able to adequately address the problem of concealed indebtedness. While the Malegam Report has recommended that a common credit bureau be created, Trident reports that MFIs are reluctant to join.

The Future of Regulation

The latter half of 2011 will be telling for the future of the microfinance regulatory regime as RBI further clarifies the acceptance of the Malegam Report and its role with regards to microfinance institutions operating as NGO-MFIs, Cooperatives, and Section 25s. Regulation will surely be refined as microfinance institutions implement the new requirements and consumers and regulators see a theoretical framework put into practice. The initial round of RBI regulation in 2011 aimed to assuage consumer fears and create an environment where bank lending will presume by directly addressing borrower indebtedness and loan pricing. We suspect that as the sector returns to a state of normalcy, some of the more restrictive requirements will be lessened or eliminated.

In the meantime, the regulation seems to heavily favor larger institutions who can adapt to the changes more easily due to economies of scale, advanced MIS systems, and higher operational efficiencies. As a result, we may see smaller institutions failing or consolidating in the near term. We may also see more innovative companies and microfinance models that aim to circumvent the new regulatory structure, especially since an institution can continue to lend to microfinance clients as an NBFC with no new regulation. Regulation will respond to these innovations as well, either by endorsing them or disallowing them, depending on fairness and the success of implementation.

The great benefit of the Andhra Pradesh crisis and the resulting call for regulation is that the sector has seen the consequences of a model that is not customer centric. Institutions, investors, and regulators agree that though there is profit to be had, microfinance services are aimed at ultimately improving the status and livelihood of the poor population. As the sector develops, regulators must be sure to address the issues we have highlighted: implementation of priority sector lending requirements, diversification of funding, and acceptance of public deposits. As we move forward, regulators will ensure that microfinance institutions' operations and objectives are ultimately to serve and benefit the customer.

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