Microfinance Industry in India: Some Thoughts

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The proposed legislation for regulation of the for-profit microfinance sector has a number of problems. It makes the Reserve Bank of India the sole regulator of the sector when this is the domain of the states rather than the central bank. The proposal will permit a back-door entry for the MFIs to collect savings which is not a healthy idea. Any proposal should be drawn on the experience of the states and the for-profit MFIs should be regulated as moneylenders.

The idea of extending financial services, in general, and banking services, in particular, to as many people as possible, was articulated in the Reserve Bank of India’s (RBI) monetary policy statement of April 2005. However, the word financial inclusion was used specifically and the policy was elaborated in the October 2005 policy statement of the RBI (paragraph 57). To the best of my knowledge, the concept of financial inclusion, as a matter of public policy, was articulated in that statement for the first time, at least in India.

In some advanced economies, the word financial exclusion was used, but that generally referred to customers of the bank who were left out because of some problem or the other with specific customers who used to find it difficult to reopen bank accounts. The idea of financial inclusion in India has logic relevant to Indian society. We felt that many people would like to keep their money safe. For instance, many working class women would like to keep their money safe from their husbands. People who have seasonal employment prefer to keep their money safely whenever they get informal work and utilise it during the period when they do not get daily wages. Sometimes, they may require small loans to smoothen consumption. More important, many parents from rural areas have to send money to their children who may be in nearby towns in hostels. There are also migrant workers who temporarily move to different parts of the country, and who may have to send money to their dependants. The “no-frills accounts” scheme of banks was introduced as part of this approach of financial inclusion. This scheme attracted some favourable attention. The Government of India (GOI) consequently announced the appointment of the C Rangarajan Committee on Financial Inclusion. The RBI, which was represented by Usha Thorat, a deputy governor, in the committee, emphasised that microcredit and microfinance should not be the major focus of financial inclusion. However, as it turned out, there was emphasis on microcredit in the Rangarajan Committee report, and follow-up actions were taken accordingly.

There was also interest in the GOI having a separate legislation for development and regulation of microfinance institutions (MFIs). As governor of the RBI at that time, I felt that such a centralised legislation would be inappropriate in regard to the microfinance movement which was meant to be essentially informal and decentralised. Initially, I got the impression that the government was convinced by my arguments. However, a decision was taken, and an announcement was made in the Union budget that a legislation would be introduced in this regard. In 2007, a bill was drafted accordingly and introduced in Parliament. During the discussions on this bill, a suggestion was made that the RBI should be the regulator. For my part, I expressed my opposition to the idea that the RBI should regulate MFIs, except in respect of non-banking financial companies (NBFCs), which in any case, fall under the jurisdiction of the RBI.

RBI Understanding of Microfinance

In brief, our understanding of microfinance was that microcredit is a small part of microfinance, and microfinance is a small part of financial inclusion, and financial inclusion is closely related to economic inclusion.

In parallel, significant interest was expressed by the RBI in regard to extending microfinance activity, essentially as extended arms of the individual branches of banks and not as parallel financial intermediaries. The concept of banking correspondents was also developed in this context. During this period, most of the MFIs were not for profit, while there were some, particularly NBFCs, other than those under Section 25, which were for profit. There was substantial microfinance activity in the southern states, and in particular, in Andhra Pradesh. Most of the activity was driven by self-help groups.
(SHGs) promoted by state governments and at the initiative of the National Bank for Agriculture and Rural Development and the banking system.

While we, in the RBI, thus played a role in bringing the subject to the forefront, I am culpable of some errors in judgment.

**Culpability**

There were early warnings of some problems in regard to microfinance institutions (NBFC-MFIs) in December 2005 when I was governor of the RBI. There were media accounts of mass agitation against lending and recovery practices, and high interest rates charged in Chittoor district of Andhra Pradesh. The regional director of the RBI requested voluntary restraint on their part in respect of the operational practices being adopted.

In March 2006, the district collector of Krishna district in Andhra Pradesh ordered an enquiry into the functioning of NBFC-MFIs there. He subjected some of the institutions to search and seizure and had them sealed by the revenue and police officials. From the RBI, we requested the regional office to call on the chief secretary to the Government of Andhra Pradesh in this regard, and he tried to bring about a reconciliation. Since the problem persisted, the RBI held a series of meetings in April 2006. A joint fact-finding survey was suggested by me, and this was done in May 2006. This was followed up by joint initiatives by the Government of Andhra Pradesh in May 2006. This included a code of conduct to be complied by the MFIs. A coordination forum was constituted, and discussions were held from December 2006, and some sort of a resolution was thought to have been achieved in June 2007.

In brief, the Government of Andhra Pradesh always had discomfort with the NBFC-MFIs, and every effort was made by the RBI to introduce a voluntary code of conduct. In retrospect, perhaps, the trust that RBI placed in these NBFC-MFIs was misplaced.

In May 2007, a formal circular was issued to all the NBFCs, expressing the concerns of the RBI and hoping for responsible conduct. Amidst other things, the circular stated:

- The RBI had been receiving several complaints regarding levy of excessive interest and charges on certain loans and advances by NBFCs.
- Though interest rates are not regulated by the RBI, rates of interest beyond a certain level may be seen to be excessive and can neither be sustainable nor conforming to normal financial practice.
- Boards of NBFCs are, therefore, advised to lay out appropriate internal principles and procedures in determining interest rates and processing and other charges.

In retrospect, given the track record, the RBI should have insisted on enforceable regulation and not been content with an advisory role.

About this time, a working group was constituted in the RBI to prepare a model Money Lender’s Act. Some states wanted NBFC-MFIs to be brought under the model law. At that time, our opinion was that the NBFC-MFIs were committed to a code of conduct consistent with the interests of the weaker sections. Hence, the RBI exempted them from the proposed model law. In retrospect, our assumption about the commitment of these institutions to the stated values was wrong.

I invited Nobel Laureate Muhammad Yunus to visit the RBI and I had the occasion to discuss this matter. He gave his unequivocal opinion that for-profit MFIs are no different from moneylenders. While I had respect for that opinion, on the basis of the assessment we made at that time we continued to trust in a reasonably defensible operating procedures of the NBFC-MFIs. Obviously, we were wrong in our assessment.

At that point of time, there was a view that the NBFC-MFIs should also be brought under the jurisdiction of the Microfinance Bill that had been introduced in Parliament. Yet, we were inclined to keep NBFC-MFIs outside the jurisdiction of such a centralised legislation.

**For-profit Institutions vs Others**

We in RBI were aware of the fundamental differences between incentives in organisations for for-profit maximisation and others. In other cases, we failed to apply that distinction in the case of NBFC-MFIs. I will give an illustration. The Infrastructure Development Finance Corporation was promoted by the RBI and GOI as a development finance institution. It was funded primarily by the government and RBI, but structured to be managed as a private company. At one stage, the management decided to go in for a public issue and raise equity in the market by listing the shares. We in RBI felt that the true development orientation would be diluted and profit maximisation would overtake its objectives, if its shares were to be listed and traded. The government was not in agreement with this view of the RBI. Hence, the RBI decided to disassociate itself with such a profit-maximising institution, and transferred its debt as well as equity to the GOI by virtually funding the purchase by the government.

However, this principled stand of the RBI was not applied to NBFC-MFIs because of a false sense of trust. Thus, the most important mistake was in failing to distinguish between the for-profit institutions especially with incentives that accompany listing and trading of the shares, on one hand, and non-profit MFIs on the other. Some of the NBFC-MFIs during the period I am referring to, were registered as Section 25 “Non-Profit Companies” or some of them received funds from donors who prescribed some amount of accountable framework in their operations.

**Realisation**

I must admit that, post-retirement, I have realised these mistakes. There has been time to introspect about past mistakes. There has been an academic orientation that has enabled me to study the developing situation. I have been able to be quite close to field conditions and the reality. I have been accessible to people and have been able to observe events; whereas when holding public office we tend to meet and hear interested parties rather than the silent majority.

In addition, the global crisis also brought about a better understanding of the incentives and other issues in regard to the functioning of the financial industry. Hence, I articulated the issue for the first time in Chennai in October 2009 in the Guhan Memorial Lecture, where I said:

Micro-finance is a respectable area, and the impressive profitability of MFI-ps in India has attracted investments from private equity funds globally, with a huge premium. There may, therefore, be merit in a detailed analysis in a sort of supervisory review, in order to check any incipient tendency towards irresponsible or usurious lending through MFI-ps. 7
Lessons from Global Crisis

It is interesting to see some parallels between the functioning of the financial industry that led to the crisis in the United States and to some extent in the United Kingdom and the for-profit MFIs in India, particularly in Andhra Pradesh.

First, the sub-prime lending in the US, essentially represented extending loans to people well beyond their capacity to repay. Second, the practices for collection through foreclosure, etc., observed after the crisis in the US, are considered to be onerous. Third, the shadow banking system involved bank-like activity by non-bank institutions often with funds raised from banks. Fourth, regulation did not take care of the liquidity issues of the entities. Fifth, there were cases of the too big to fail, requiring public policy support to ensure their survival. Sixth, the relationship between the financial sector and real economy was not fully appreciated. Financial transactions multiplied and the financial sector grew disproportionate to the growth in the real sector. After the crisis, it was realised that the financial sector can enable but cannot lead to economic development. For example, financial inclusion may not be possible if people are not economically included, that is, if they are at the subsistence level and below the poverty line. In this regard, a cross country comparison based on statistics indicating the percentage of population that is financially included is misleading since 30-40% of the population are, in any case, below the poverty line in India. Excessive financialisation in this background leads to problems for both lenders and borrowers, as happened to individual borrowers in the US.

All these features, to some extent or the other, are found in the “for-profit” MFI industry in India. In fact, a similarity can be found in considering, on an urgent basis, legal changes in the regulatory framework to “save the industry”.

Existing Models in Andhra

The features of the existing models of for-profit NBFC-MFIs in Andhra Pradesh are worth examining so that a view can be taken as to whether the models themselves are sustainable and whether modifications are needed. First, there was concentration risk on the assets side, since a large part of the activities of major entities were confined to a few districts of one state, viz, Andhra Pradesh. Second, the model had significant policy risk in the sense that its successful operations depended on special public policy support that was designed in one state. Third, there has been concentration risk on the liabilities side in the sense that most of its resources were from banks and through securitisation, which was in turn financed essentially by select banks. Fourth, there was a de facto entry barrier since the institutions operated on the basis of an initial advantage of the pre-existing SHGs in Andhra Pradesh, which had been nurtured over a long time. The for-profit MFI could, as Shyamala Gopinath, former deputy governor of the RBI said, “ride on” them. The supply of such SHGs in AP was simply not inexhaustible. In fact, the government and some states expressed discomfort at this “poaching”. Fifth, there was a false assumption that most of the financing by for-profit MFIs was done to finance creation of productive assets and a cash flow that will enable payment of interest, over and above the principal, by the borrowers. Empirical evidence does not validate this assumption. In other words, the methodology of assessment of credit worthiness was wrong. Another view is that, the borrowers were replacing moneylenders’ funding with borrowing from for-profit MFIs on cost considerations. Sixth, there was an assumption that people working in these MFIs were committed to a value framework that aims at profit-making but not profiteering or profit maximisation. The organisational structures and incentive frameworks as well as lifestyles of senior managers did not validate this assumption. In fact, many of the talented people employed in these organisations have deserted it at the first sign of trouble. Finally, the assumption that for-profit MFIs are committed to a particular activity, viz, microcredit for the poor, has also become suspect going by the plans of some of these institutions to enter the gold loan business.

Proposed Model

The proposed models of regulation, as indicated by the RBI and government, have some common characteristics. Since the basic features of proposed models are well known, I will only comment on them.

First, the policy and regulatory framework proceed on the assumption that for-profit MFIs are essentially moneymaking, organised financial intermediaries with some specialisation in dispensing what may be called small ticket loans. Further, proposals include use of credit records, ratings, etc. The original features of MFIs in terms of informality, small community-based assessment, decentralised approach and a holistic approach to providing credit, along with other production-related services do not get fully reflected in the proposed models.

Second, the proposed models attempt at what may be treated as softer regulation in terms of capital adequacy, etc. It may be recalled that exactly similar arguments were made in favour of softer regulation in regard to urban cooperative banks. That experience has been not very happy. Third, the RBI has been brought into the picture as the sole regulator in the proposed model. At a broader level, many analysts, and especially those who believe in for-profit organised microfinance, have been arguing that the RBI should not be a regulator for banks on the grounds that it will remove its focus from its main function, viz, monetary management. More important, the RBI does not have the organisational presence in the rural areas where the MFI activity is concentrated. In my view, the RBI may be unnecessarily exposed to serious reputational risks. In any case, it will be virtually impossible for the RBI to conduct its regulation and supervisory functions in rural areas without full cooperation of the state governments. Fourth, the need for a distinction between “for-profit” MFIs and “not-for-profit” MFIs and a distinction between MFIs which concentrate only on finance (in which case they become financial intermediaries) and others which undertake credit and productive activities on a package basis is not very clear. Fifth, extension of credit is equated with financial inclusion, which is totally inappropriate. Payment services and deposit taking are two most important pillars of financial services, and most people are keen about these two services. Further, financial inclusion cannot be totally divorced from economic inclusion.

PERSPECTIVES

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Sixth, the proposed models amount to replacing informal moneylending with organised, institutionalised, centralised and leveraged moneylending. Is this a better approach than others? Seventh, the proposed model may result in a situation where there are two systems of financial services, viz, banking for the non-poor and for-profit MFIs for the poor. There is a danger that this divide will develop into an interest in perpetuating itself. Alternatively, the for-profit MFIs will make a back-door entry into banking without satisfying the essential requirements.

The present thinking of including thrift as one of the functions of MFIs allows a back-door entry into banking by these institutions. Softer regulation of MFIs in relation to banks which are deposit-taking institutions poses a very serious danger to the integrity and stability of the financial sector, as a whole.

**Way Forward**

Being an academic now, I can venture to make some suggestions about the possible approaches on the way forward.

MFIs activity as an extension of individual branches of the banks concerned will help expand the reach of the banks over a period, while taking advantage of semi-formal systems. It is also useful to examine whether the existing rural cooperative sector or otherwise, could be a better channel to provide micro-finance loans. In fact, there are other successful models of what have been described as alternative banking – such as in Brazil.

The existing for-profit MFIs should not be treated as holy cows, and it should not be assumed that somehow they should be saved because they are the best options available for serving the public interest. On the basis of available evidence, the actual operations of for-profit MFIs are not different from moneylenders. Hence, they need to be regulated as moneylenders. Even if the for-profit NBFC-MFIs are treated as financial intermediaries, they should absorb the risks and draw upon equity, while lenders should be willing to write off or reschedule as per normal business practices.

Adding the function of thrift to MFIs and subjecting them to softer capital adequacy and leverage norms should be eschewed at any cost.

Depending on the institution, dual regulation is not inappropriate. While the RBI can regulate some of the features of for-profit MFIs as a financial intermediary, the state governments’ jurisdiction in regard to moneylending by the for-profit MFIs should be respected. The Constitution rightly gives specific jurisdiction to states in respect of moneylending business.

From a technical point of view, the nature of activity, viz., microfinance, is such that it is best regulated in a decentralised fashion, and hence at the state level also.

Some people believe that state governments are not as efficient, forward looking and sensitive as the central government. I will share my experience in this regard. Andhra Pradesh took the lead in application of it in the government and in e-governance in the 1980s. At that time, the GoI had provided, through the National Informatics Corporation, a national network of computers and inter-connectivity free of charge for all the state governments to utilise them. It was almost binding on the state governments to use the national network. Yet, the Government of Andhra Pradesh decided to spend its own money and create an institution called the Andhra Pradesh Technology Services, which took its own path of moving ahead with computerisation in a decentralised fashion. This initiative of AP gave it a lead in e-governance. Similarly, its initiatives helped develop the MFI movement in India. Undermining such state-level initiatives in response to policy change by the state governments through a national-level legislation prepared at the instance of industry sounds less than proper and prudent.

**Conclusions**

Much of what I have discussed here is related to my work in the RBI and more recently the experience of Andhra Pradesh, but this is significant since the contemplated regulations of RBI and the contemplated legislation by the government are almost entirely in response to the MFI activity in Andhra Pradesh. It is important for the debate to consider the MFI experience, and indeed the experience in regard to financial inclusion in the rest of the country, objectively, and then consider whatever actions are required. It is appropriate that the for-profit institutions that have taken risks should bear the risks of the lenders, especially banks who have lent money to these institutions. This will ensure that moral hazard problems do not arise in future and that national-level legislation is based on a wider experience, particularly in states where MFI activity has been successful on a sound basis.

In viewing the way forward, it is important to recognise that moneylenders constitute an important segment. A systematic study about the transaction cost incurred, the burden on the borrowers and the scope for improvement would provide a framework for bringing moneylenders from the informal to somewhat formal sector, and slowly into the more formal banking sector. Such a broader approach would require a careful consideration and strengthening of the moneylender legislation at the state level.

In addressing the issue of MFIs, it is necessary to clarify some conceptual issues. First, how does one distinguish financial services from credit services? Second, how does one ensure that the institutions which perform bank-like functions are subjected to bank-like regulations? Third, for profit-institutions undertaking financial activity can be divided into two categories, viz, financial intermediaries which should be subject to regulation like any financial intermediary, and moneylenders who should be subject to legislation on par with moneylenders. Fourth, the important issues of centralisation and decentralisation cannot be ignored in dealing with issues relating to millions of people. Finally, the support of state governments is critical in this regard, and the recent schemes of ensuring the opening of a bank account for purposes of disbursement is an extremely laudable initiative, since it provides a vehicle for providing financial services in general, and for enabling some sort of economic inclusion. This model should be pursued with greater vigour and with the cooperation of the state governments.

**Note**  
1 A revised version of the lecture was published as “India’s Financial Sector in Current Times”, Economic & Political Weekly, 7 November 2009.