Understanding the structure of Micro Finance Institutions in India and suggesting a Regulatory Framework

Dr. Prakash Singh
Faculty (Finance & Accounting Area),
IIM Lucknow

92

BLANK

Contents

Synopsis of the Proposal

Chapter 1: **Page No.**

The journey of microfinance in India

- Concept of Financial Inclusion 103
- Failure of the Conventional Models 103
- Birth of Microfinance 104
- Status of Microfinance in India 105
- Microfinance Business Model 106
- SHG formation process 107
- Legal Structure 107
- Financial Analysis 108
- Social Analysis 110

Chapter 2:

Detailed Comparison of the various Business Models of MFI

- Qualitative comparison of the legal forms 117
- Methodology of the study 119
- Performance analysis of the selected MFI's for the study 120
- Major findings of the study 120
- Major findings and conclusions of the comparative study 124

Chapter 3:

Regulation

- Introduction 126
- The Rationale for Regulating Microfinance 127
- Challenges of Microfinance Regulation 129
- Areas of concern 132

References 145

94

BLANK

Table of Contents

S.No.	Title/Subject	**Page No.**
	Synopsis of the proposal	
1	Introduction and Background	97
2	Issues with Microfinance	97
3	Literature Review	98
4	Regulatory Framework	100
5	Building a Case for Regulation	101
6	Specific Research Objectives	102
7	Research Methodology	102
8	Deliverables	102

96

BLANK

Synopsis of the Proposal

1. INTRODUCTION AND BACKGROUND

Financial Inclusion is the delivery of financial services to all the people in a fair, transparent and equitable manner at affordable cost. Financial Inclusion has the potential to improve the standards of life of the poor and the disadvantaged as financial services permit individuals and households to manage the risk and uncertainties to save on better terms, to invest in a business venture or property or to cope with unforeseen expenses. The cause of poverty in developing economies among other things is that the poor does not have access to credit for the purpose of working capital as well as investment for its small business (Jean-Luc, 2006). Households with low income often lack access to bank account and have to spend time and money for multiple visits to avail the banking services, be it opening a savings bank account or availing a loan. Thus, the unbanked public is largely cut off from the Banking products/services. It is the endeavour of the government/ banks to provide the basic banking facilities to all the un-banked. Financial inclusion has also been defined from another angle as well viz., opposite of financial exclusion, which signifies the lack of access by certain segments of the society to appropriate, low-cost, fair and safe financial products and services from mainstream providers.

Microfinance emerged in the early 1990's to provide credit and savings services to the poor as a possible alternative to conventional bank lending. Many developing economies have developed and have been providing credit to the poor through microfinance schemes. The experience of several Asian, African as well as Latin American countries could be a typical example for this (Meyer, 2002). It received further boost with involvement of several non-governmental organizations and microfinance institutions. These efforts led to the formation of Self Help Groups (SHGs), where poor from homogeneous backgrounds formed groups of around 20 each and pooled money that was lent to the needy in the group. With huge potential and low NPAs, several private and foreign banks, unveiled their plans to enter the Indian microfinance sector. The government and the RBI have announced several measures to boost microfinance activities in the country. However, there is lot to be done by the regulator in the light of the recent developments in this sector. The few specific developments worth mentioning here are:

- Exponential growth, witnessed in the Micro Finance Industry lately, with more and more institutions coming in every day. Although there is no reason to press the panic button as of now but surely the regulator needs to keep a tab on the recent spurt of activity in this sector.
- With more and more funds required for the established MFI's to scale up; and because of the regulatory prohibition on raising deposits, the profitable MFI's are offering their equity stakes to banks and FI's, who are more than willing to put their money in these more or less established and highly profitable MFI's in return for an Equity stake.
- With alternative models, being proposed now to further Financial Inclusion, including Agent based banking, Mobile based banking, the next big question would be the "Transaction Cost", as to which of the alternative models would have the lowest transaction cost.

2. ISSUES WITH MICROFINANCE

It is clear from the previous discussion that though some significant strides have been made in up-scaling the Microfinance Industry, but there are some areas of concern too. Some of the issues, which need the attention of the policy makers, urgently are:

- **Structure and sustainability Issues:** Currently, the structure of the MFI's in India is either the SHG Model or the JLG Model and there are large numbers of MFIs who practice one of these models. The choice of the model adopted may not be a scientific process exactly, and could be more driven by convenience and transaction costs which the concerned MFI is willing to incur. The choice of the model has a huge impact on the long term sustainability of the MFI and is largely an irreversible decision. There is already a concern on the sustainability of the abnormal growth rate at which the sector is growing and the need is for a structural, optimized model.
- **Funding Issues:** Steady access to Capital is an issue coupled with heavy dependence on Banks

and Financial Institutions which makes the sector even more vulnerable. A steady access to capital will remain a key challenge for India's MFI sector over the medium term. Capital infusions and internal accruals have helped most MFIs enhance their net worth over the past two years. Recent rounds of capital infusion have helped NBFC-MFIs reduce gearing despite high growth in their asset base. On the other hand, non-profit MFIs and cooperatives reduced their gearing on the back of improved internal accruals, conversion of security deposits to capital and reduced borrowings because of lack of availability of funds. As the MFIs are dependent on borrowings from banks and FIs, and do not raise debt from the capital market, the large NBFC-MFIs face higher cost of borrowing. The large and mid-sized MFIs and NBFC-MFIs primarily borrow from private and foreign banks, while the smaller MFIs borrow mainly from private banks and apex lenders. Lending model plays an important role in determining an MFIs borrowing profile. PSBs prefer lending directly through the SHG-bank linkage route, accounting for 36% of the total borrowings against only 10% of the MFIs following the JLG model.

- **Capacity Building Issues:** Increasing pressure on processes and controls due to aggressive growth plans and it remains to be seen as to how the MFI's live up to this unique challenge. Also, MFIs risk management practices have weakened over the past couple of years, on account of a shift in focus towards business growth and network expansion. Some credit sanction and monitoring practices have been diluted. Rapid expansion to new geographies also put pressure on the internal control mechanisms and audit functions. Some improvements have benefited the MFIs from the technical support. Strong internal audit and control has been the key differentiator to grade the MFIs. MFIs will need to restructure their internal audit and control processes to minimize operational risks during the growth phase.
- **Regulatory Issues:** Absence of a regulatory control is a sort of a mixed blessing. On one hand, this has helped in mushrooming of huge number of MFI's but at the same time, this has led to some malpractices and reporting practices, whose ethical standards are questionable. Microfinance activities are undertaken by the organizations that are registered under the several legal forms. The absence of prudential norms and accounting guideline for non-NBFC-MFIs leads to lack of uniformity and highly leveraged balance sheets among MFIs. Savings is an important component, but currently savings and deposit services can be offered only by banks and cooperatives. The regulatory risk involved in allowing NGO-MFIs to collect savings/deposits has resulted in MFIs ceasing to mobilize savings and deposits.
- **Weak Governance Architecture:** MFI have a strong bearing on governance practices because they influence management practices and levels of transparency. Legal structures suffer from want of adequate regulations and disclosure standards. This creates a vicious circle phenomenon. NGO-MFIs continue to face challenges in striking a balance between their social and business goals. This results in poor internal control systems, lack of accountability, and sub-optimal performance. This will ultimately hinder the sustainability of their operations.

3. LITERATURE REVIEW

Poverty is the major problem in most developing economies. In these economies, it is argued that among others absence of access to credit is presumed to be the cause for the failure of the poor to come out of poverty. Meeting the gap between demand and supply of credit by the formal financial institutions frontier has been challenging (Von Pischke, 1991). In fact, the gap is not aroused merely because of shortage of loanable fund to the poor; rather it arises because it is costly for the formal financial institutions to lend to the poor. Lending to the poor involves high transaction cost and risks associated with information asymmetries and moral hazards (Stiglitz and Weiss, 1981). Nevertheless, in several developing economies governments have intervened, through introduction of microfinance institutions to minimize the gap and allow the poor access credits.

Microfinance is the provision of financial services to the poor people with very small business or business projects (Marzys, 2006). Only a small fraction of the world population has access to financial instruments, essentially because commercial banks consider the poor people as unbankable due to their lack of collateral and information asymmetries. There are a number of

studies in the MF industry because it has got the attention of academicians and practitioners as an innovative method of fighting poverty. The studies mostly concentrate on three key areas. The first one is impact assessment of the MF programs on the lives of the poor. It is to mean that whether the provision of financial service mostly of credit and saving has improved the lives of the poor in terms of economic, social and political indicators of poverty. The studies about the impact of the microfinance in changing the lives of the poor have shown mixed results (Hishigsuren, 2004). The key findings from most of the impact studies have revealed varying degree of positive impact on program participants notably increase in household and enterprise income and assets. Mixed effects were found in employment, schooling of children and women's empowerment. So the evidence on whether Microfinance can alleviate poverty is a highly debated issue.

The second hot area in the MF industry among researchers is whether MF reaches the poorest of the poor who is in need of financial services. There are studies that show that MF doesn't reach the poorest of the poor. Rather they are reaching the marginally poor or non-poor. Besides most MFI's have no clear rules and criterion to target the poorest of the poor (Hishigsuren, 2004). This indicates that the MFI's are drifting away from their original mission of reaching and serving the poor. The third area that got the attention in the MF industry is the issue of financial sustainability of MFIs. Historically MFI has started operation with donor funds and now the industry has almost aged around 30 years. There is an intense debate on whether MFI's should continue to be donor supported or get relieved from donation and stand on their own leg. There is one school of thought who says that MFI should be sustainable with donor funds (called welfarists) and the others say that the MFI should generate enough revenue to cover their own costs as donors funds are unpredictable (called institutionist) (Basu and Woller, 2004). Hence the issue of building a sustainable MFI industry that can operate without a donor funds is of an empirical enquiry.

There are also different arguments concerning how to evaluate the performance of microfinance institutions. Meyer (2002), Citing from Zeller and Mayer (2002), indicated that there is what is called "Critical Micro-finance Triangle" that we need to look at to evaluate Micro-finance institutions based on their objective. Here, the corners of the triangle represent outreach to the poor, financial sustainability and welfare impact. And "Performance criteria are required for each objective and all three must be measured thoroughly to evaluate micro-finance performance," noted Meyer (2002). Navajas et al (2000), similarly, indicated that there are six aspects of measuring outreach: depth, worth of users, cost to users, breadth, length and scope. Where, depth of outreach refers to "the value the society attaches to the net gain from the use of the micro credit by a given borrower," Navajas et al (2000).

There are also some dispute on the link between financial sustainability and outreach to the poor. According to some (Christen et al 1995; Otero and Rhyne, 1994), cited in Meyer (2002), outreach and financial sustainability are complimentary, as this is because of the fact that as the number of clients increase, MFIs enjoys economies of scale and hence reduce costs which help them to financial sustainable. On the other hand, Hulme and Mosely (1996) argued that there is an inverse relationship between outreach and financial sustainability. Here the argument is that higher outreach means higher transaction cost in order to get information about creditworthiness of clients and hence make MFI financially unsustainable including credit in the production function can be used to assess impact of MFI's. But, Scholars like Aklilu (2002) critic that it is wrong because this kind of assessment involves complications; probably it could be difficult to sort out loan effects from technical assistance. Regarding indicator of financial sustainability, Sureda (2005) pointed out that loan repayment (measured by default rate) could be another indicator for financial sustainability of MFI's; because; low default rate would help to realize future lending. The micro finance institutions participation in several developing economies is escalating from time to time. Various studies on different countries on the performance of the MFIs confirm the argument that performance is not a straight forward issue (Adongo and Stork, 2005, Zeller and Meyer, 2002, Meyer, 2002, Robert cull et. al. 2007).

With growth of the microfinance sector and increasing competition among MFIs, it is expected that interest rates may exhibit tendency to fall. In a study of three mature microfinance markets, Bangladesh, Indonesia and Bolivia, Porteous (2006) found that competition appears to be putting a downward pressure on interest rates only in the latter two countries. While the poverty focus and wide outreach of Bangladeshi MFIs and their

lower interest rates from the beginning may be important explanatory factors, the lack of financial literacy of the MFI customers compounded with the lack of uniformity among MFIs in the manner of quoting interest rates, were found to be other important limiting factors.

It is only recently that most countries have started seriously addressing microfinance regulation. Hence the possibility of learning from the experience of other countries is limited. A few examples from countries where microfinance sector has a reasonable history are however taken into account in the suggested framework for India. An early model of regulation developed in Indonesia involved the central bank as the regulator, with delegation of supervision to a Government owned bank, Bank Rakyat. Indonesia (BRI) and some provincial banks (Maegher, 2002). In the Philippines, performance standards have been developed in a collaborative manner by stakeholders in the sector, including representatives from Government, private sector as well as wholesale and retail MFIs. These standards are meant for use as industry benchmarks for all types of MFIs (Almorio et al, 2006). Bangladesh has enacted regulation of the sector only in 2006 when a Central Authority to regulate microcredit was set up.

4. REGULATORY FRAMEWORK

The financial regulatory framework in a given country can have a huge impact on even the liability of microfinance. The models of legal organization, registration requirements, interest rate caps, capitalization, etc. are all determined by the legal framework or lack thereof. Although Microfinance regulation is still a heavily debated topic and is not yet well understood, it is integral to any study that endeavours to understand the costs and benefits of different institutional forms. Banks in India are regulated and supervised by the Reserve Bank of India (RBI) under the RBI Act of 1934, Banking Regulation Act, Regional Rural Banks Act, and the Cooperative Societies Acts of the respective State governments for cooperative banks. NBFCs are registered under the Companies Act, 1956 and are governed under the RBI Act. There is no specific law catering to NGOs although they can be registered under the Societies Registration Act, 1860, the Indian Trust Act, 1882, or the relevant state Acts. There has been a strong reliance on self-regulation for NGO-MFIs and as this applies to NGO-MFIs mobilizing deposits from clients who also borrow. This tendency is a concern due to enforcement problems that tend to arise with self-regulatory organizations. In January 2000, the RBI essentially created a new legal form for providing microfinance services for NBFCs registered under the Companies Act so that they are not subject to any capital or liquidity requirements if they do not go into the deposit taking business. Absence of liquidity requirements is concern to the safety of the sector.

One of the main constraints of NGO-MFIs is the ability to mobilize deposits in order to diversify their funding sources and grow. This constraint stems from the RBI Act which states that no unincorporated bodies are allowed to accept deposits from the public. Therefore, the right to collect deposits from the general public is restricted to regulated institutions, and only cooperatives and NBFCs are subject to prudential regulations. This means that NGO-MFIs may collect deposits only from their members, but are not subject to prudential regulation. Greater supervision of NGO-MFIs 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. Microfinance activities of NGO-MFIs are not expressly stated as one of the "charitable purposes" in the preamble to the Societies Registration Act. Therefore, the carrying out of lending activities and charging interest could easily lead to the denial of charitable status, although this has not widely happened as of yet. Therefore, a major concern for NGOs that might affect their decision to transform to an NBFC is the loss of charitable status which entitles them to a tax exemption on interest collected. Lastly, NGOs face the regulatory constraint of not being able to receive shareholder contributions, leaving them with the options of donor and government funds.

The transformation from NGO to NBFC is difficult when the minimum start-up capital requirement for registering as an NBFC being Rs 20 million or US$ 450,000, often too large an amount for most NGO MFIs. The main problem with the minimum capital requirement is that MFIs are restricted to bringing in the capital as fresh money, meaning that NGOs are not allowed to invest capital in a non-charitable institution. This restriction makes transformation more difficult and might be the reason we mainly see transformation of large NGO MFIs with better access to capital. Also, for all MFIs there is a strong concern that interest rate caps can be introduced by state governments under existing state legislation. The introduction of interest rate caps for any

MFI, but especially NBFCs which need to generate a profit, could prohibit ongoing operations if the imposed interest rate cap does not cover the cost of lending. All of these issues impact the decision an MFI makes when it decides to transform from an NGO to an NBFC because they represent benefits and costs to transformation.

5. BUILDING A CASE FOR REGULATION

There is growing interest in Microfinance Institutions (MFIs) as one of the avenues to enable low income population to access financial services. India with a population of around 350 million poor people has emerged as one of the largest potential opportunity for the microfinance sector. With approximately 45% of the population accessing financial services, expanding the microfinance sector is also important from the perspective of financial inclusion. The RBI has identified the growth of Microfinance Sector as an important avenue through which the broader national goal of providing broad range of financial services accessible to increasing proportion of population is achieved. The Reserve Bank has also helped in attracting funding for the sector by including microfinance in the "priority sector", to which banks are mandated to allocate a percentage of their lending. However, no specific regulation was imposed on the sector as a whole primarily because it was felt that regulation may hamper the sector's key strengths of informality and flexibility.

With the growth of the sector both in terms of size, scope and number of participants, there is, however, now a need for developing a more formal regulatory structure. There are three or four main areas where the regulation is absolutely necessary. First, regulation is needed to address the need for access to savings instruments for these MFIs and affordable remittance and payment services for low income groups. Currently, the microfinance sector focuses primarily on lending. Most of the growth in microfinance in India has been concentrated on provision of loans or "microcredit". Regulatory constraints have contributed to this focus. A few large MFIs with satisfactory track records can be permitted to convert into MFI banks so that they can provide savings as well as remittance services. Given the large geographic area of the country, licenses to collect deposits need to be provided selectively to entities, so as to enable effective regulation. Changes in current provisions to introduce innovations in service delivery, such as permitting MFI banks to partner with mobile companies to offer mobile banking services merit serious consideration. Such innovations can substantially reduce transaction costs and facilitate progress towards the goal of financial inclusion. However, the introduction of savings services by the MFIs, has to be preceded by putting in place a framework for their prudential regulation.

The second area of regulation concerns non-prudential regulation, which does not involve systemic risk but is essential for good governance and orderly development of the sector. This area involves transparency with regard to charges, mitigating mis-selling of financial products, operating practices such as monitoring and collection of loans, and norms for provisioning of loans. This is the more visible side of the MFI operation as it involves the public face and the recent round of disrepute to the sector is largely because of poor management on part of MFIs on this front. Had there been a regulatory mechanism in place, much of the negative publicity could have been avoided.

Thirdly, microfinance sector institutions are no longer solely socially motivated. Due to the growing perception that it is possible to earn high returns through microfinance lending, commercially driven entities are also being attracted to the sector. This further underlines the need for supervision and consumer protection. Also, some MFIs have started offering products such as insurance, remittances and pensions by tying up with mainstream providers. While this helps in broadening the scope of microfinance services, it also calls for coordinated regulation of the sector particularly in view of the limited financial literacy of its participants. Such increasing overlap between various financial institutions is expected to continue. Finally, while the diversity of legal forms in the sector has arisen due to its unplanned, entrepreneurial growth, a uniform regulatory framework would enable a level playing field and prevent regulatory arbitrage.

All the above mentioned reasons and few more point to the fact that this is a sector which has huge potential to grow and partially fulfil the broad objective of Financial Inclusion for an Inclusive Growth of the country, but growth comes with problems and issues, which were never thought of initially and, therefore, it is the right time to address the concerns of the industry and come out with a clear policy framework. Also, we must not forget that while regulation is essential, but over regulation that hampers innovation and unduly increases transaction costs, is also equally a matter of concern.

6. SPECIFIC RESEARCH OBJECTIVES

1 In light of the significant interest and recent controversies (post SKS IPO) generated in the sector, there is a pressing need to come out with some clear policy guidelines to regulate the sector. The question we try to answering here is: Who this regulator should be? What should be the scope of regulation and what should be its mandate?

2 The next question would be regarding regulating what and how much, so as to maintain the balance between growth and prudence. For example, the reporting practices can be regulated, but can the interest rates too be capped or regulated?

3 With alternative legal modes of existence for Microfinance facilitation, this study would try and study each legal mode and look at there specific constraints and accordingly recommend to the regulator.

7. RESEARCH METHODOLOGY:

The study has been conducted primarily by looking at the Financial Statements and other financial data of the existing Micro Finance Institutions in India where attempt has been made to investigate all legal forms of Microfinance Institutions, prevalent in India. Also, primary information has been collected by visiting the villages-where the concept is working, and also the villages where the concept is yet to be implemented. The tools would include in-depth interviews, and questions-with the persons affected; and detailed discussions with bankers/other government functionaries-involved with these kinds of projects. Thus, this study is largely based on primary data interacting with MFI and analyzing their numbers and looking at some recent regulatory measures.

8. DELIVERABLES

Deliverable 1

- Study of various forms/business models of Micro Finance Institutions in India and a look at the transition in the changing regulatory environment in light of recent controversies etc.

Deliverable 2

- Study of what all variable (interest rates, minimum capital requirement, transaction cost, risk premium estimation etc) needs to be regulated right from the birth of an MFI to its commercialization.

Deliverable 3

- Analyzing the regulatory bottlenecks in each form/ structure of Microfinance institutions in India and accordingly suggesting a ideal regulatory framework for sustainable development of all models of MFI's and thus ushering real Financial Inclusion.

CHAPTER-1

The Journey of Microfinance in India

This chapter introduces the concept of Microfinance and traces its origin in India. It also looks at how the existing models could not really help the cause of Financial Inclusion resulting into the birth of Microfinance Institutions. It briefly dwells on the various forms of business models in which they exist in India and the current status of Microfinance in India.

1.1 CONCEPT OF FINANCIAL INCLUSION

The recent developments in banking technology have transformed banking from the traditional brick-and-mortar infrastructure like staffed branches to a system supplemented by other channels like automated teller machines (ATM), credit/debit cards, internet banking, online money transfers, etc. The moot point, however, is that access to such technology is restricted only to certain segments of the society. Indeed, some trends, such as increasingly sophisticated customer segmentation technology - allowing, for example, more accurate targeting of sections of the market - have led to restricted access to financial services for some groups. There is a growing divide, with an increased range of personal finance options for a segment of high and upper middle income population and a significantly large section of the population who lack access to even the most basic banking services. This is termed as "financial exclusion". These people, particularly, those living on low incomes, cannot access mainstream financial products such as bank accounts, credit, remittances and payment services, financial advisory services, insurance facilities, etc.

Deliberations on the subject of Financial Inclusion contributed to a consensus that merely having a bank account may not be a good indicator of financial inclusion. The ideal definition should look at people who want to access financial services but are denied the same. If genuine claimants for credit and financial services are denied the same, then that is a case of exclusion. As this aspect would raise the issue of creditworthiness or bankability, it is also necessary to dwell upon as to what could be done to make the claimants of institutional credit bankable or creditworthy. This would require re-engineering of existing financial products or delivery systems and making them more in tune with the expectations and absorptive capacity of the intended clientele. Based on the above consideration, a broad working definition of financial inclusion could be as under:

"Financial inclusion may be defined as the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost". Households with low income often lack access to bank account and have to spend time and money for multiple visits to avail the banking services, be it opening a savings bank account or availing a loan Thus, the unbanked public is largely cut off from the Banking products/services. It is the endeavor of the government/banks to provide the basic banking facilities to all the un-banked. Financial inclusion has also been defined from another angle as well viz opposite of financial exclusion, which signifies the lack of access by certain segments of the society to appropriate, low-cost, fair and safe financial products and services from mainstream providers.

1.2 FAILURE OF THE CONVENTIONAL MODELS

Regional Rural Banks (RRBs): The establishment of the Regional Rural Banks in 1975 was one among the various policy initiatives taken by the Indian government to broaden the outreach of formal credit systems to the rural population. The birth of RRBs heralded a new era of the Indian banking and their role was envisaged in the context of overall development of rural economy, which consists of poor, poverty stricken, unemployed and illiterate masses. The rationale of setting up of RRB as laid down in the preamble of RRB Act 1976 is to provide adequate fillip to the rural sector by the provision of the adequate and timely finance. The initial expectation was thus to bridge the gap between the rural poor and urban rich.

Rural credit and its recovery are still remaining as a challenge for the bankers as well as the planners. The RRBs because of the predominance of rural sector in their operational domain are severely affected by the default syndrome. The large volume of NPA (Non Performing Assets) coupled with high operational

expenses has generated heavy accumulated losses for RRBs. Particularly during the era of liberalization, criticism has been raised over the viability of RRBs. Being the custodian of public money they have to augment the existing resources through generation of more money, side-by-side meeting that avowed objectives enshrined in the Act. But the failure of these banks has put question mark on their functioning. During the ongoing liberalization phase, where accountability of public financial institutions is gaining more importance in the society, these RRBs have not shown the desired results. Their viability and effectiveness in managing rural credit are still under scrutiny. The fundamental reason for this financial failure is considered to be as the RRBs have never been allowed to charge for their services at rates which compensate them for the costs of operation and in particular for the costs of bad debts.

Several measures were taken in the past to improve the performance of the RRBs. These included a programme of recapitalization to the extent of Rs 2,188 crore (starting 1994-95), a proposal to merge RRBs sponsored by the same bank (1991), and closing of non-profitable branches (2002). In addition, they have been encouraged to issue Kisan Credit Cards, and use Microfinance as a mechanism to reach the poor by promoting and lending to SHGs. The deregulation of interest rates has gone a long way in making RRBs competitive and market savvy. RRBs, post-merger, represent a powerful instrument for financial inclusion. Their outreach vis-a-vis other scheduled commercial banks, particularly in regions and across population groups facing the brunt of financial exclusion, is impressive. RRBs account for 37% of total rural offices of all scheduled commercial banks and 91% of their workforce is posted in rural and semi-urban areas. They account for 31% of deposit accounts and 37% of loan accounts in rural areas. RRBs have a large presence in regions marked by financial exclusion of a high order. They account for 34% of all branches in North-Eastern, 30% in Eastern and 32% in Central regions. Significantly the more backward the region the greater is the share of RRBs which is amply demonstrated by their 56% share in the North-Eastern, 48% in Central and 40% in Eastern region. RRBs are, thus, the best suited vehicles to widen and deepen the process of financial inclusion. However, there has to be a firm reinforcement of the rural orientation of these institutions with a specific mandate on financial inclusion.

Cooperatives: Rural credit cooperatives in India were originally envisaged as a mechanism for pooling the resources of people with small means and providing them with access to different financial services. A chain of cooperatives were set up in India to serve the poor in urban and rural areas. The major development in the cooperative field since Independence was the appointment of Rural Credit Survey Committee. In its report it was revealed that in the field of rural credit, in spite of half a century of cooperative effort, the private agencies still reigned supreme and institutional agencies for credit only played an insignificant part. The cooperative supplied only 35 per cent of the total borrowings of the agriculturists. Further, that even this little cooperative credit has reached only the wealthier members of the village who own creditworthy securities, and needs of the poor farmers have not been satisfied.

Besides, large part of the country was not covered by the cooperatives. Even from the point of better business, there was substantial deviation between cooperative principles and cooperative policy and from that character and repaying capacity, as judged by local knowledge and kept under review by local vigilance, cooperative credit at a very early stage gravitated to ownership and landed security. The reasons for the cooperative failure of the cooperative credit structure were functional, structural and administrative defects, dearth of suitable personnel to conduct the affairs of the societies, lack of training a background of mass illiteracy, the grave and chronic deficiency in a village communications, storage and other vital economic requirements. Other causes were related to certain fundamental weaknesses which had developed in the structure.

1.3 BIRTH OF MICROFINANCE

Credit unions and lending cooperatives have been around hundreds of years. However, the pioneering of modern microfinance is often credited to Dr Mohammad Yunus, who began experimenting with lending to poor women in the village of Jobra, Bangladesh during his tenure as a professor of economics at Chittagong University in the 1970s. He would go on to find Grameen Bank in 1983 and win the Nobel Peace Prize in 2006. The UN Year of Micro-credit in 2005 indicated a turning point for Microfinance as the private sector began to take a more serious interest in what has been considered the domain of government. However, with all the excitement about the prospects of the field to contribute

to poverty alleviation and the integration of the world's poor into the rapidly evolving global market system, the Consultative Group to Assist the Poorest (CGAP) estimates that microfinance probably reaches to fewer than 5% of its potential clients. Although this is a very rough estimate of those not reached by formal financial institutions, it might serve to provide a general idea of what share of the potential clients of microfinance have yet to be reached. India is home to a growing and innovative sector of microfinance. With a large portion of the world's poor, India is likely to have a large potential demand for microfinance. For this reason, it makes sense to consider the changing face of microfinance in India, in order to shed light on comparable changes in the field all over the world.

A complete understanding of the evolution and nature of a country's financial system, regulation, and government attitude toward the sector is integral to understanding the nature of microfinance in any particular country. Such knowledge allows one to understand what forces shape its growth and what factors constrain it. Understanding the nature of microfinance regulation is especially important to assessing the costs and benefits of transforming from a NGO-MFI to an NBFC-MFI because regulation outlines the nature of some of those benefits and costs while also providing the legal basis for the different types of legal form an MFI can take. The World Bank has called South Asia the "cradle of microfinance". Statistics indicate that almost half of all the people in the world who use microfinance services are living in South Asia. However, the overall percentage of the poor and vulnerable people with access to financial services remains small, amounting to less than 20% of poor households in India. The World Bank estimates that more than 87% of India's poor cannot access credit from a formal source and therefore they are not borrowing at all or have to depend on money-lenders who charge them interest rates ranging from 48% to 120% per annum and sometimes much higher. This demonstrates that there are potential clients for microfinance in India, depending on the level of demand for financial services, from those poor without access to it.

1.4 STATUS OF MICROFINANCE IN INDIA

Microfinance in India has grown at a tremendous pace in recent years, achieving significant outreach amongst the poor as well as non-poor (but low-income) households across the country. Linkages between banks and Self-Help Groups (SHGs) supported by the National Bank for Agriculture and Rural Development (NABARD), on one hand, and Microfinance Institutions (MFIs), on the other, have emerged as the two most prominent means of delivering microfinance services in India. Growth in terms of outreach across both models has been very high.

Over the last ten years, however, successful experiences in providing finance to small entrepreneur and producers demonstrate that poor people, when given access to responsive and timely financial services at market rates, repay their loans and use the proceeds to increase their income and assets. This is not surprising since the only realistic alternative for them is to borrow from informal market at an interest much higher than market rates. Community banks, NGOs and grassroots savings and credit groups around the world have shown that these micro-enterprise loans can be profitable for borrowers and for the lenders, making microfinance one of the most effective poverty reducing strategies. To be successful, financial intermediaries that provide services and generate domestic resources must have the capacity to meet high performance standards. They must achieve excellent repayments and provide access to clients. And they must build toward operating and financial self-sufficiency and expanding client reach. In order to do so, microfinance institutions need to find ways to cut down on their administrative costs and also to broaden their resource base. Cost reductions can be achieved through simplified and decentralized loan application, approval and collection processes, for instance, through group loans which give borrowers responsibilities for much of the loan application process, allow the loan officers to handle many more clients and hence reduce costs (Otero et al, 1994). The recent trend in the sector is captured in the Table below.

Table 1

Overall progress under Micro-finance during the past 3 years

Particulars		2007-08		2008-09		% Growth (2008-09)		2009-10		% Growth (2009-10)	
		No. of SHGs	Amount	No. of SHGs	Amount	No. of SHGs	Amount	No. of SHGs	Amount	No. of SHGs	Amount
A. SHG-Bank linkage Model											
Savings of SHGs with Bank as on 31 March	Total SHGs	5009794	3785.39	6121147	5545.62	22.2	46.5	6953250	6198.71	13.6	11.8
	Out of which SGSY	1203070	809.51	1505581	1563.38	25.1	93.1	1693910	1292.62	12.5	(17.3)
Bank Loans disbursed to SHGs during the year	Total SHGs	1227770	8849.26	1609586	12253.51	31.1	38.5	1586822	14453.30	(1.4)	17.9
	Out of which SGSY	246649	1857.74	264653	2015.22	7.3	8.5	267403	2198.00	1.0	9.1
Bank Loans outstanding with SHGs as on 31 March	Total SHGs	3625941	16999.91	4224338	22679.84	16.5	33.4	4851356	28038.28	14.8	23.6
	Out of which SGSY	916978	481687	9768.87	5861.72	6.5	21.7	1245394	6251.08	27.5	6.6

B.(I) MFI-Bank linkage Model										**(in crore)**
Particulars	**2007-08**		**2008-09**		**Growth during 2008-09 (%)**		**2009-10**		**Growth during 2009-10 (%)**	
	No. of MFIs	**Amount**	**No. of MFIs**	**Amount**	**No. of MFIs**	**Amount**	**No. of MFIs**	**Amount**	**No. of MFIs**	**Amount**
Bank Loans disbursed to MFIs during the year	518	1970.15	581	3732.33	12.2%	89.4%	691	8062.74	18.9%	116.0%
Bank Loans outstanding with MFIs as on 31 March	1109	2748.84	1915	5009.09	72.7%	82.2%	1513	10147.5 4	(21%)	102.6%

Note : Actual number of MFIs provided with bank loans would be less as several MFIs could have availed loans from more than one bank

Source: NABARD State of the Microfinance Sector Report, 2010

1.5 MICROFINANCE BUSINESS MODEL

The microfinance business model is designed to address the challenges faced by the traditional financial services sector in fulfilling the credit requirement of the low income segment at an affordable and sustainable cost. A Joint Liability Group (JLG) is an informal group comprising preferably of 4 to 10 individuals coming together for the purposes of availing bank loan either singly or through the group mechanism against mutual guarantee. The JLG members would offer a joint undertaking to the bank that enables them to avail loans. The JLG members are expected to engage in similar type of economic activities like crop production. The management of the JLG is to be kept simple with little or no financial administration within the group. JLGs can be formed primarily consisting of tenant farmers and small farmers cultivating land without possessing proper title of their land.

A Self-Help Group (SHG) is a registered or unregistered group of micro entrepreneurs having homogenous social and economic backgrounds; voluntarily coming together to save regular small sums of money, mutually agreeing to contribute to a common fund and to meet their emergency needs on the basis of mutual help. The group members use collective wisdom and peer pressure to ensure proper end-use of credit and timely repayment. This system eliminates the need for collateral and is closely related to that of solidarity lending, widely used by microfinance institutions. To make the book-keeping simple enough to be handled by the members, flat interest rates are used for most loan calculations.

Besides, the plain vanilla structure, the Indian microfinance industry comprises NGOs, trusts or societies working on a not-for-profit model, and even bigger players - like Spandana, SKS, Basix, Share Microfin in Andhra Pradesh, Cashpor in Uttar Pradesh, Grameen Koota in Karnataka -which work on a for-profit model The microfinance industry is estimated to cover about 10 per cent of poor households in need of credit. MFIs first emerged in the late 1990s to raise social and commercial funds for lending to the underprivileged. Today there are over a thousand Indian MFIs, most of which service the rural poor. Several MFIs have also discovered the potential in lending to the urban poor. Uplift, an association of urban MFIs, Society for Promotion of Area Resource Centres (SPARC), Swadhar FinAccess, Bandhan and Ujivan, are among the MFIs that operate in urban areas. Banks find it difficult to lend to MFIs in the absence of sufficient collateral. Hence, several MFIs have transformed themselves into Non-Banking Finance Companies (NBFCs) to widen their capital base.

Adding to the appeal are interest rates of 25% to 35% that microfinance lenders are able to charge borrowers; they justify such rates by claiming high costs in the delivery of their loans to largely untested customers. As a result, in India, today both international and Indian banks are striking partnerships with MFIs. In addition, some foreign venture funds have also entered the microfinance field, hoping to maximize their returns and also benefit from the relatively low default rate. Several international players like the International Finance Corporation (IFC), Washington, US-based ACCION, UK-based CDC, Tridos of the Netherlands, FMO, a Dutch organization and Germany's KfW have made significant investments in India's micro finance sector. Individuals and foundations set up by the likes of Vinod Khosla, founder of Sun Microsystems, Unitus Equity Fund, the Michael and Susan Dell Foundation and the Bellwether Fund, have also infused funds into the sector.

1.6 SHG FORMATION PROCESS

Village Selection: The branch manager does a village survey and thereafter selects certain villages where there is scope for promotion of groups A number of village meetings are conducted in the selected villages.

Group Formation and Training

After a number of meetings, one or more groups are formed. Each MFI has its own norm for the number of members in a group. A number of MFIs have a norm of 5 members per group Each group usually has two leaders. On forming a group, the field worker commences training of the group members and the group leaders. On completion of the training, a Group Recognition Test (GRT) is held. As part of the GRT there are visits to the residences of the members. The field worker's supervisor may also be involved in the GRT. The members are tested on MFI principles taught during the training.

Appraisal, Documentation and Disbursement

On successful completion of GRT, the field worker at the next group meeting brings the prepared documents and members sign them. The cost of stamp paper, revenue stamp, photograph, copies of documents if applicable is shared by group members. At the next meeting disbursement of the loan takes place. In some MFIs, all members receive the loan amount simultaneously after documentation, while in others some members receive it initially and other members after two weeks.

Monitoring and collection

The field worker after disbursement makes loan utilization checks (usually one or more depending on the MFI norms). The loans are usually for a period of 50 to 55 weeks with weekly collections. Hence the groups meet every week.

Schedule of field workers

Most group meetings are held in the early morning hours. Each field worker has a schedule of group meetings to attend in the mornings. There after he/she goes to the office to complete the administrative tasks. The evenings are kept for field work, either to form new groups or to provide training to newly formed groups.

1.7 LEGAL STRUCTURE

India is the largest microfinance market in the world, with the sector growing at an average rate of over 50 per cent. Consequently, it is attracting domestic and foreign investors and new players, who are hoping to practice profitable philanthropy. Its growth performance was impressively sustained through the liquidity crunch and continued at an increased rate in the second half of 2009. As of March 2009, the MFIs in India reported a client base of 226 million with an outstanding portfolio of more than $2 billion. Over the past five years, the sector has delivered a CAGR of 86% in the number of borrowers and 96% in portfolio outstanding. In the 12 months from March 2008 to March 2009, the

microfinance industry experienced a 59% growth in its client base from 142 million to 226 million and 52% growth in its portfolio outstanding which increased from $15 billion to $23 billion. This reflects a 14% increase in the absolute growth in portfolio outstanding and 33% increase in the absolute growth in the number of borrowers from 2008 to 2009. (Source: www.mixmarket.org)

The main forms of legal status or organizational forms used by microfinance institutions in India are Non-Governmental Organizations (NGOs), Non-Bank Financial Companies (NBFCs), Local Area Banks (LABs), Cooperative Societies under the Cooperative Society Act, and Public Societies/Trusts

- A Non-Governmental Organization (NGO) is a legally constituted organization created by natural or legal persons that operates independently from any government and a term usually used by governments to refer to entities that have no government status. In the cases in which NGOs are funded totally or partially by governments, the NGO maintains its non-governmental status by excluding government representatives from membership in the organization. The term is usually applied only to organizations that pursue some wider social aims.
- With a view to provide institutional mechanisms for promoting rural savings as well as for the provision of credit for viable economic activities in the local areas, establishment of local area banks came into existence.
- A cooperative may be defined as a business owned and controlled equally by the people who use its services or by the people who work there. Cooperative enterprises are the focus of study in the field of cooperative economics.
- An association having objects to promote commerce, art, science, religion, charity or any other useful purpose and not having any profit motive can be registered as non-profit company under section 25 of the Companies Act, 1956. This section empowers the Central Government to grant a license directing that such an association may be registered as a company with limited liability, without the addition of the words 'Limited' or 'Private Limited' to its name.
- NBFC is a company registered under the Companies Act, 1956 of India, engaged in the business of loans and advances, acquisition of shares, stock, bonds, debentures and securities issued by government or local authority, or other securities of a marketable nature, leasing, hire-purchase, insurance business, or chit business; but does not include any institution whose principal business is that includes agriculture or industrial activity; or the sale, purchase or construction of immovable property.

2.2.1 Financial Analysis:

Financial analysis is required for many financial management decisions such as how to manage the finances to achieve the strategic goals of the institution, how to increase profitability, how to reach self-sufficiency/break-even point, how to increase efficiency especially reducing the cost per client, what is the optimum level of each different operational expense including the cost of funds etc.

Indicators for Financial Analysis: Indicators generally compare two or more pieces of data, resulting in a ratio that provides more insight than do individual data points.

2.2.1 (i) Sustainability and Profitability:

Self-Sufficiency indicators are calculated to determine financial viability. To be financially viable, an MFI cannot rely on donor funding to subsidize its operations. Profitability ratios measure an MFI's net income in relation to the structure of its balance sheet. These help investors and managers determine whether they are earning an adequate return on the funds invested in the MFI. Profitability and sustainability ratios in traditional financial analysis reflect the ability of the MFI to cover its operations and grow in the future using its own funds. Most MFIs are striving for some level of greater financial independence, whether they are non-profit or for-profit.

2.2.1 (ii) Asset Liability Management:

Asset Liability Management (ALM) is the process of planning, organizing, and controlling asset and liability volumes, maturities, rates, and yields in order to minimize interest rate risk and maintain an acceptable profitability level. An MFIs liquidity is directly affected by ALM decisions.

2.2.1 (iii) Capital Adequacy : Leverage (Debt/Equity Ratio)

The Debt to Equity ratio measures the relationship between the risk-weighted (debt) assets of the MFI and its equity. It indicates how much of a safety cushion the

institution has to absorb losses before creditors are at risk. It also shows how well the MFI is able to leverage its equity to increase assets through borrowing. It is usually an important ratio for investors and lenders and different industries will have different benchmarks for debt to equity. The commercial banking sector has some of the highest levels of debt to equity as their primary business is lending. However, since microfinance is a slightly different type of lending, commercial debt to equity ratios are not really good comparisons. The Micro Banking Bulletin put out by CGAP at the World Bank provides benchmarks for MFIs. Depending on the capitalization and loan portfolio of the MFI, average debt to equity ratios range from 130% to 540% depending on the size and target market of the MFI. The Debt to Equity ratio should be compared against these industry benchmarks to give an idea of the risk of the MFI due to its degree of debt. An MFI must be wary of borrowing more than it can repay in times of trouble.

2.2.1 (iv) Portfolio Quality:

Portfolio quality ratios provide information on the percentage of non-earning assets, which in turn decreases the revenue and liquidity positions of an MFI. These are used to measure portfolio quality and to provide other information about the portfolio. Portfolio quality is important to the financial success of any microfinance institution. Drops in portfolio quality could be an indication of decline in customer satisfaction and thus a low retention rate. It could also signal problems in staff supervision and control if it is the result of poor staff performance. Whatever the case, poor asset quality will result in additional costs and lower income.

2.2.1 (v) Efficiency and Productivity:

Efficiency and Productivity ratios provide information about the rate at which MFIs generate revenue to cover their expenses. Productivity refers to the volume of business that is generated for a given resource or asset. Efficiency refers to the cost per unit of output. Both can be used to compare performance over time and to measure improvements in an MFI's operation.

Some of the key financial performance ratios are highlighted in the Table below

Table 2:

Summary of Key Financial Performance Ratios

Parameters (All India)	2003	2005	2007	2008
Outreach (averages)				
Members/MFI	21,235	34,265	96,347	215,406
Borrowers/MFI	7,770	20,908	74,086	183,243
Loan size (Rs)	6,562	11,509	8,117	11,480
Loan balance (Rs)	3,336	4,257	3,381	4,944
Savings per member (Rs)	762	300	211	191
Savings to portfolio ratio	62.40%	11.50%	8.10%	4.50%
Credit performance				
Portfolio at risk (>60 days overdue)	12.20%	4.70%	6.40%	2.9%
Efficiency and productivity				
Members per staff	335	359	296	276
Borrowers per staff	122	219	228	234
Portfolio per MFI (Rs Million)	26	89	251	906
Portfolio per staff (Rs lakh)	4.1	9.3	7.7	11.6
Borrower/member ratio	36.60%	61.00%	76.90%	85.10%
Earnings/expenses				
Portfolio yield (weighted)	18.80%	25.20%	24.80%	24.60%
Financial cost ratio	10.30%	9.10%	9.80%	
Operating expense ratio (weighted)	19.90%	15.60%	15.90%	11.10%
Loan loss provision	1.80%	5.20%	0.90%	
Total expense ratio	27.70%	36.00%	21.90%	
Operating cost per borrower (Rs)	548	581	504	457
Profitability and sustainability				
Return on assets (weighted)	-1.50%	2.10%	0.00%	3.00%
Operational self sufficiency (weighted)	88.20%	108.00%	92.00%	122.40%
Financial self sufficiency (weighted)	76.80%	102.00%	87.00%	115.40%
Leverage				
Capital adequacy ratio (weighted)	33.10%	20.60%	12.70%	17.10%
Debt: Equity ratio	1.42	5.2		
Asset allocation				
Loans to total assets	62.10%	73.60%	75.00%	77.40%
Cash	5.60%	6.10%	10.00%	12.50%

Source: State of Microfinance in India, Institute of Microfinance Report (2009)

Recent Performance of the Sector (Source: <u>www.mixmarket.org</u>), 2009.

<u>Clients and Portfolio</u>

The microfinance sector in India has developed a successful and sustainable business model which has

been able to overcome challenges traditionally faced by the financial services sector in servicing the low income population by catering to its specific needs, capacities and leveraging pre-existing community support networks As of March 2009, microfinance institutions ("MFIs") in India reached over 22 million borrowers and had a portfolio outstanding in excess of $2.3 billion. This reflects a 14% increase in the absolute growth in portfolio outstanding and 33% increase in the absolute growth in the number of borrowers from 2008 to 2009.The microfinance business model in India typically generates a Return on Equity ("ROE") of between 20% and 30%, driven by financing from commercial banks, strong operating efficiency and high portfolio quality. Despite achieving rapid growth with a CAGR of 86% in loan portfolio outstanding and 96% in borrowers over the last five years, the microfinance sector still faces a large unmet demand which means that it still has great potential for continued growth.

Poverty Outreach

The Quick Report on key parameters of working of MFIs published by Sa-dhan reported on the MFIs coverage in poorest districts as per NREGP (phase 1 and 2) identified poorest districts. Out of these 331 poorest districts, MFIs have expanded their operations from 63% per cent in 2008 to 71% per cent in 2009 In total, they operate in 413 districts all over India. The proportion of women clients in the total clients in the current year remained same (80 per cent) as that in 2008. About 93 per cent of active borrowers are women in 2009. MFIs served 7.7 million clients from SC/ST & minority community background. About 20 per cent of MFI clients belong to SC/ST. The proportion of SC/ST clients declined from 30 per cent in 2008 to 20 per cent in 2009. While there is an increase in the percentage of borrowers above Rs10,000 from 2008 to 2009, a decrease in percentage of borrowers below Rs. 5,000/ is observed. It may be accounted to increased loan size and more matured clients.

Borowings and net owned funds

MFIs borrowing from banks has grown by 89% from March 2008 to March 2009; after 104% in the previous 12 months End of March 2009, it amounted to Rs 99.2 billions. Net owned funds have expanded by an annual factor of more than 2.5 since 2007. End of March 2009, they amounted to Rs 23.0 billions.

2.4 SOCIAL ANALYSIS:

2.4.1 Double and Triple bottom line

While all businesses have a conventional bottom line to measure their fiscal performance-financial profit or loss-enterprises, like Microfinance Institutions, which seek a *second* bottom line, look to measure their performance in terms of positive social impact also. The double bottom line approach can be applied to both public and private sector organizations. By doing things that are socially responsible, they are also benefiting in a way that significantly increases their ROI. This also allows them to build a more loyal customer base, what some are calling a "strong tribe" - internally and externally. The **triple bottom line** (abbreviated as **"TBL"** or "3BL", and also known as **"people, planet, profit"** or **"the three pillars")** captures an expanded spectrum of values and criteria for measuring organizational (and societal) success: economic, ecological and social. In practical terms, triple bottom line accounting means expanding the traditional reporting framework to take into account ecological and social performance in addition to financial performance. According to the stakeholder theory, the business entity should be used as a vehicle for coordinating stakeholder interests, instead of maximizing shareholder (owner) profit. In this case, "stakeholders" refers to anyone who is influenced, either directly or indirectly, by the actions of the firm.

2.4.2 Defining Success in Micro credit

Microfinance delivery can vary widely in method as well as social and economic benefits produced; therefore, each analyst will look at different factors in determining its success. Opinions regarding the relative importance of the various benefits and costs will differ, implying that no single measure of "success" in the delivery of microfinance will be appealing to all analysts. Thus in comparing the performance of diverse institutions, this work will employ a broad range of measures of impacts and costs, including both measures that are popular in the existing literature, and few additional measures In particular, the measures seek to highlight the practices that best enable a microfinance institution to provide services to poor clients in a manner that is financially sustainable, meaning continuing access to funds, and that creates social value.

Financial measures highlight the financial and operational viability of an MFI by focusing on measures of efficiency and profitability while social and organizational measures focus on the nature of

management, vision, target market, management of human resources, focus, and product availability, etc. Doing this involves understanding the differences across various legal structure of MFIs in what they consider their priorities and what constitutes success, especially with regards to what segment among the poor they are reaching. It will be especially important to understand not only the differences in contextual constraints that each MFI faces but also what program design and organizational details help them achieve their goals in the specific context they face.

In order to achieve its mission, an MFI needs to exhibit a degree of financial soundness that will allow it to sustain its operations into the future in order to continue to deliver its services and achieve its desired social impact. A basic financial analysis is an integral and necessary part of the evaluation process of an MFI. A set of ratios and indicators are normally compiled from industry sources in order to aid in putting together a picture of each MFI. Some of these ratios are commonly used ratios in financial analysis of publicly held companies while some are more specific to banking and microfinance. While they provide a concrete picture of the MFI's operations, they do not provide a complete picture of the MFI's impact. It is necessary to complement these financial ratios with a study of strategic and social impact indicators to get a more holistic picture of the MFIs and compare them.

Reporting on social performance by micro-finance institutions (MFIs) is still largely anecdotal in the absence of a clear, industry-wide, accepted framework for social performance reporting. It can be seen as a complement to, and on equal footing with, financial performance also allowing comparison between peer groups of MFIs. In the future one can expect diminishing resources for development assistance from public donors. At the same time, there is a growing interest for Microfinance on the part of private social investors. In this setting, it would be important for MFIs to develop the capacities for the simultaneous pursuance of financial and social objectives, and for reporting on it in a manner which can stand the test of external auditing on both accounts. This can also help to improve understanding of possible trade-offs between economic and social returns on investment. Most MFIs have a social mission. They may be working, for example, to broaden access to financial services, reduce poverty, empower women, build community solidarity, or promote economic development and regeneration. Social performance refers to the extent of their success in meeting these goals.

2.5 DIMENSIONS OF SOCIAL PERFORMANCE WITH RESPECT TO MICROFINANCE

We distinguish four major dimensions of social performance as follows:

1 **Outreach to the Poor and Excluded:** MFI have generally been developed to reach a population excluded from the classical financial system. MFIs can have the objective of reaching socially excluded populations or the poor, or simply to offer financial services in a region where classical banking systems are absent. The depth of outreach of the MFI can be measured to evaluate its focus on the economically and socially excluded population.

2 **Adaptation of the services and products to the target clients:** It is not enough to decide to reach a target population. The MFI must learn about the target population and work on the design of its financial services so that they can fit with the needs and the constraints of the clients. "Pro-poor" services are too often standardized. Social performance indicators can analyze the process leading to service definition and the extent to which the MFI knows about its clients' needs.

3 **Improving social and political capital of clients and communities :** For the MFI, trust between the MFI and the clients can reduce the transaction costs and improve repayment rates. It thus can foster collective action and reduce free-riding, opportunistic behavior, and reduce risks. For the clients, strengthening their social and political capital can enhance their social organization (collective action, information sharing, political lobbying, etc). Social performance indicators should measure the degree of transparency, the effort of the MFI towards giving voice to its clients within the organization and beyond (community, local government, national government, etc).

4 **Social responsibility of MFI** Social awareness is a necessary pre-requisite for socially responsible corporate behavior. Social responsibility requires an adaptation of the MFI corporate culture to their cultural and socio-economic context, an adequate human resource policy, credit guarantees adapted to the local conditions, and balanced relationships

between staff and clients (in particular in MFIs where there are elected clients who participate in decision making). The proposed indicators are summarized as follows:

2.6 SOCIAL PERFORMANCE INDICATORS:

Some of the core social performance indicators are:

- Range of products and services
- Training of staff
- Market research on clients
- Social responsibility to staff
- Geographic outreach Women's outreach
- Poverty assessment
- Employment Children in school
- Clients below the poverty line

2.6.1 Outreach/Scale

Number of loans extended per year, Number of loans extended since inception :

The number of loans extended per year and since inception shows the ability of the MFI to reach more clients and achieve a degree of scale. However, effectiveness will depend also on portfolio quality.

Borowers per Loan Officer (Number of Active Borrowers/Loan Officers);

Similar to the ratio of Active clients to staff member, the ratio of Borrowers per Loan Officers gives an indication of both the profitability and scale achieved by an MFI's loan officers. To have significant impact, MFIs should strive for the highest ratio of borrowers per Loan Officer possible before portfolio quality is compromised. This ratio should be evaluated in light of portfolio quality to ensure that greater scale and outreach doesn't significantly affect portfolio quality.

Number of Products offered;

The number of products offered per MFI assesses financial deepening, evidence by a greater depth of products offered to the same client base as opposed to a greater number of the poor reached with credit. It also shows the organization's ability to innovate and have greater impact on each client. The number of products includes the various types of loans in terms of duration and purpose, savings services, and insurance. Poor clients have little or no access to financial services, thus an MFI's ability to offer more than credit to clients is an indication of its greater potential to improve their lives by helping them to build capital through savings or mitigate risk with insurance.

2.6.2 Customer Retention

Client Turnover (Number of Active Clients, End of Period + Number of New Clients During Period - Number of Active Clients, Beginning of Period/Average number of Active Clients) Client Turnover measures the net number of clients continuing to access services during the period and is used as one measurement of client satisfaction. It represents the change in active clients during the period as a percentage of average active clients. The term "turnover" rather that "loss" is used for this ratio because some clients may leave or become inactive for a period of time. The Client Turnover ratio is used to determine the level of client satisfaction with the MFI's products and services. Often, clients leave MFIs due to lack of flexible and demand driven products. The ratio is important because it is generally accepted that the cost of retaining clients is significantly lower than the cost of recruiting new clients.

2.6.3 Poverty Alleviation

Number of clients crossing the poverty line: This is a basic impact assessment tool that gives a rough idea of whether the MFI is achieving poverty alleviation. However, it will not capture any movements between segments of poverty, such as a movement from being 'very poor' to 'moderately poor,' which we might also consider poverty alleviation. This is a general statement that shows how well an MFI does in targeting poor clients based upon those considered poor by either national standards of living on less than $1 a day, or by rough measure of loan size as used by some MFIs. Some MFIs such as BASIX have used small loan size as a rough estimation of whether their clients are likely to be 'poor'. The challenge here will be to find data that is comparable as MFIs tend to have varying ways of measuring social impact using different measures.

Average Outstanding Loan Size: (Gross Loan Portfolio/Number of loans outstanding): Average outstanding loan size measures the average outstanding loan balance per borrower and is widely used as a rough proxy for the depth of outreach among lower income clients. It is recommended as no other suitable indicators have won broad consensus. Although a number of factors other than income level of the client contribute to smaller loan sizes, there is a correlation between this ratio and the average income level of the

areas served. Therefore, it might be useful to monitor this ratio in light of GNI per capita and cost per client.

Geographical Concentration: Is the MFI operating in poor areas? Or does it concentrate in urban areas or somewhat higher income areas? If the MFI operates in areas that are generally considered poor then it has a much higher likelihood of actually having the poor as the majority of its customers.

1.10 FINDINGS OF THIS CHAPTER

- The Indian microfinance sector has two major models for microfinance delivery - the SHG Bank Linkage Programme (SBLP) and the MFI model. While the MFI model is growing rapidly, the SBLP is by far the more dominant model in terms of outreach. Both these models are very different from each other in methodologies adopted and legal forms of institution involved in service delivery. SBLP is promoted by the apex agricultural bank (NABARD) through the commercial banks while the MFI model is privately managed with some institutions being regulated by the Reserve Bank of India.
- The MFI model uses a variety of methodologies ranging from the very popular SHG methodology traditionally pursued in the country to Grameen and joint liability groups, as well as individual banking arrangements. Over the years, through an ongoing process of experimentation and innovation, Indian MFIs now largely follow a mixed approach customized to their target segment and area of operation.
- In addition to the microfinance delivery methodologies, MFI management approach, services and performance are influenced by their legal form - ranging from not-for-profit Societies/ Trusts and not-for-profit Companies registered under Section 25 of the Companies Act to NBFCs licensed by RBI. In terms of model and legal forms, Grameen organizations accounted for about 78% of membership (in terms of methodology) while (organizationally) NBFCs covered 65% of outreach. This proportion has been growing over the years, which is evident from the fact that in 2003 the SHGs and NGOs accounted for the majority of microfinance coverage. The main reason has been the transformation of MFIs into commercial entities and adopting the Grameen model to meet their growth requirements.
- Like SBLP, the outreach of MFIs is also concentrated in the traditional southern region, with about a 75% share. However, in the last couple of years many south based MFIs have started to operate in other regions as well and the share of the south is expected to decline in the years to come, NBFCs comprise a substantial proportion of the portfolio outstanding. The share of NBFCs in portfolio outstanding has grown from 50.5% (2005) & 71.3% (2007) to 76.0% currently. The NBFCs also have about a 70% share of the borrowers. In this context, the proposal to bring societies, trusts and cooperative MFIs under a separate regulatory framework from that of NBFCs would mean regulatory exclusion of a major proportion of microfinance clients.
- There is a high degree of concentration in the microfinance portfolio. The Top 10 MFIs account for over 64% of the total portfolio. The reasons for this are related to the efficiency, financial performance and microfinance methodology and legal forms of the MFIs. Most of the Top 10 MFIs are NBFCs adopting the Grameen model for operations.
- The size of the average loan balance held by borrowers of Indian MFIs as a proportion of GNI per capita (a quick indicator of depth of outreach) has increased to 13.0% in 2008 from 9.9% in 2007. The Top 10 MFIs record a slightly lower loan size-GNI ratio of 11.7%, and has consistently dropped over the years NBFCs have the highest loan size-GNI ratio of 14.1%. This shows their emphasis on having large loan sizes than other models right from the first loan cycle.

MAJOR FINDINGS AND CONCLUSIONS

Financial Performance Analysis (Aggregate Data)

- Staff productivity in Indian MFIs has improved consistently over the years and has now reached a level that is considered to be amongst the best in major regions offering microfinance. The productivity measured in terms of portfolio handled per staff and borrowers per staff was Rs 11.6 lakh ($29,000) and 234 borrowers respectively. The NBFCs and Grameen model were the most efficient in comparison with other legal forms and models.
- The operational efficiency of Indian MFIs, measured by OER, has improved over the years

and across all types of MFIs. The weighted average OER in 2008 is 11.1% (lower than the 15.9% in 2007). This emphasizes the high operating efficiency of the Indian MFI as compared to those internationally, owing to the economies of scale. Indian MFIs have achieved over the years. Better operating efficiency has also resulted in a reduction in cost per borrower which was about Rs 457 ($11.5) in 2008.

- Analysis also indicates that Indian MFIs have been able to maintain a good portfolio quality in 2008 after a major fall in 2007. Grameen organizations in India have been the best performers with PAR30 of 2.1% while IB seems to have a riskier portfolio with PAR30 at 8.7%. Across various institutional types, NBFCs and Sec- 25 companies are among the best performers as most of them follow the typical Grameen methodology.
- Debt has become the dominant source of finance for Indian MFIs. The share of debt in MFI finances was high at 71.9% in 2008. The share of client savings and grants has reduced over the years. One reason is the increased awareness of MFIs as profit making entities which should have low reliance on grants. Another reason is the regulatory restriction on most MFIs in the mobilization of deposits.
- The allocation of funds by Indian MFIs is very fairly productive. Of the total resources deployed in microfinance by the sample MFIs, nearly 77% was deployed in loans to clients in 2008. The allocation of funds to loans has seen an increasing trend over the years.
- The financial viability of MFIs has also improved. Overall the MFIs registered a weighted average RoA of 3.0% reflecting good profitability from microfinance operations. The overall picture on sustainability is quite encouraging. Analysis of OSS and FSS indicates that the Indian MFIs have become more sustainable. This is mainly attributed to better management of operating and other expenses by the large and relatively young organizations.

Social Analysis (Aggregate Data)

In the context of overall declining poverty rates in India and the relatively small (micro) size of micro-credit the data indicates the following :

- Primarily rural outreach, though MFIs are beginning to expand into urban/city areas.
- Depth of outreach (% new microfinance clients below the poverty line) at an estimated 58% below the national poverty line for SBLP (compared to the All India figure of 17% households below the national poverty line). Lower poverty outreach for MFIs, with data benchmarked to the international poverty lines (20% of new clients below the $1.08 poverty line, 62% below the $2/day line, compared to All India household poverty levels of 25% below the $1.08 line, and 75% below the $2/day line).
- Moderate coverage of marginal communities - Scheduled Castes and Scheduled Tribes at around 30% compared to their 27% in the population.
- An estimated 62-63% of micro-credit is used for direct productive investment; 37-38% is used for other household needs. Poorer clients are more likely to use credit for consumption smoothening.
- Annual dropout rates of 8-11 % on average.
- Some evidence for poverty reduction for those who stay with microfinance: 58% to 33% poor based on recall for the SBLP, 38%-30% comparing longitudinal wealth rank data for MFI clients. Continuing poverty for one-third of clients, after 5 years with microfinance.
- More evidence for poverty alleviation - in terms of reported increase in incomes, and in assets.
- With women accounting for 94-95% of microfinance clients, a high proportion of women (around two thirds on average) report positively on qualitative indicators of empowerment. Quantitative data indicates variation in women's engagement in financed enterprises, with some evidence for 'loan-pass' (38% of financed enterprises are managed by a husband or son) and not much change over time. Women's ownership of assets in terms of perceived joint ownership with men in the households has increased.
- There are some interesting examples of women's agency and empowerment at the community level, especially through the SBLP.
- Education of children does not follow automatically with microfinance, and continues to be a gap.

- Competition between MFIs, and overlap between MFIs and SBLP, is emerging in some areas of the country. Whilst overlapping membership limits the extent of financial inclusion that is being achieved at the household level, qualitative data signals the risk of over-indebtedness.

2.7 Indian Microfinance in the Global Context

It is critical to evaluate the progress of the Indian microfinance sector within the context of global microfinance. With one of the highest growth rates globally since 2002, the Indian microfinance sector has emerged as one of the most socially conscious, commercially viable, and financially sustainable. According to a MIX market study, India has one of the lowest average loan sizes of around $150 as well as the lowest yield on portfolio of 212%. The small loan size combined with the low interest rates testify to the social inclination of Indian MFIs, which seek to genuinely foster financial inclusion among the poor and alleviate poverty. In conjunction with this goal, Indian MFIs have succeeded not only in comfortably covering costs, but also returning healthy profits and Return on Assets (ROA). This highlights Indian MFIs' operational efficiency and ability to function on tight budgets. MFIs in other countries such as Brazil and Mexico have higher profit margins, but they offer significantly larger loans with interest rates typically between 40-65%. The inherent efficiency and resiliency of the Indian microfinance industry proved critical during the recent financial meltdown during which growth continued unabated despite a slowdown in the flow of funds which negatively affected growth in microfinance in other markets around the world. This demonstrated self-sustainability is prognostic of the long term viability and potential of the sector. Moreover, the Indian financial system as a whole has demonstrated its long-term confidence in the industry through its own investment choices. Whereas the global average of domestic investment in microfinance hovers around 65%, over 90% of the funding in India comes through domestic channels, highlighting confidence in the underlying business model and expectations of high future growth and returns.

As of December 31, 2010, there were 1,410 MFIs globally with an estimated borrower base of 86 million with a total outstanding portfolio of over $56 billion as reported by the MFIs to the Microfinance Information Exchange or "MIX Market", excluding MFIs that do not report to MIX Market. If they did report, the total size of the global microfinance industry is estimated to be roughly 200 million borrowers. From 2003 to 2009, the global industry experienced a growth in borrowers at a CAGR of 12% and a portfolio outstanding CAGR of 34%. Inter-regionally, South Asia, East Asia and the Pacific region had the highest growth rates in terms borrowers, and Sub-Saharan Africa, Middle East and North Africa have experienced the slowest growth Latin America continues to lead in terms of portfolio outstanding with $16 billion or 36% of the total global portfolio; however, South Asia has the lead in terms of borrowers with over 50% of the global borrower base. The disparity between these two trends is explained by the variance of average loan sizes in the two regions, which is a product of their economic well-being and the business models followed by their respective microfinance sectors.

Table 3:

Performance of Microfinance Institutions: A Global Perspective (2009-10)

Parameters	Global Average	Europe and Central Asia	South East Asia (India)	Latin America (Mexico)
Financial self sufficiency	1.11	1.04	1.17	1.10
Operational self sufficiency	1.23	1.14	1.28	1.15
Adjusted Return on Assets	0.01	0.1%	3.4%	3.2%
Adjusted Return on Equity	0.1%	2.3%	25-30%	203%
Average loan size to GNP per capita	0.63	0.54	0.46	0.41
Average Age of the MFI	11.12	7.42	8.24	13
Real Gross Portfolio Yield	0.31	0.39	0.28	0.56
Operating Expense Ratio	14.3%	27.7%	19.3%	13.5%

Parameters	Global Average	Europe and Central Asia	South East Asia (India)	Latin America (Mexico)
Personnel Expense to Assets	11.34%	10.5%	9.7%	7.3%
Loan loss provision Expense Ratio	3%	3.5%	1.8%	1.6%
Loans to Assets	0.7	0.71	0.78	0.67
Borrower per staff member	155	140	240	120
Borrower per loan officer	270	260	300	224
Average loan size to GNP per capita of the poorest 20%	4.8	5.4	0.47	0.41
Average Loan Size (USD)	565	860	150	880
Women borrowers	0.46	0.63	0.87	0.80
Portfolio Risk	0.04	0.3	0.03	.03

Source: Mix-market.org

Looking at the comparative performance (table above) of the MFIs across the globe, it is easy to recognize that Indian MFIs have performed much better compared to global standards, both in terms of profitability as well as social impact by keeping the average size of the loan small. The small average size of the loan indicates that Indian MFIs have consciously targeted the poorest segment of the society. Even then, they have been able to generate a descent ROA and a very low level of non performing loans (reflected in the PAR). The average gross yield is around 28% which also indicated that Indian MFIs have not charged exorbitant interest rates (average yield of MFIs in Brazil and Mexico is in the range of 50-65%. Therefore, the message coming out is very clear Indian MFIs have kept the loan size small, interest rates low and have still managed to reflect good profitability. By keeping the loan size low deliberately, they have delivered well on Social performance. Obviously, keeping the average loan size low means the transaction cost would be high. And also, the number of borrowers per staff member is also high which may result in poor monitoring resulting in higher delinquencies but that has not been the case as the loan loss provision continue to be very low. Also, the percentage of really poor people is high in case of Indian MFIs and majority of the borrowers are women.

CHAPTER-2

Detailed Comparison of the Various Business Models of MFI

Several initiatives have been tested to explore alternative ways of delivering credit to the poor. A key approach that has been evolved, has been the bank-NGO-SHG-poor linkage. This approach consists of successive layers of a principal-agency relationship where (1) a bank lends to an NGO; (2) the NGO lends to an SHG; and finally (3) the SHG lends to individual members of the group. Under this approach, the NGO or SHG secures loanable funds from various sources, including a bank, and acts as a credit intermediary to reach individual poor borrowers. This approach works under the assumption that the agency in each of the successive layers has comparative advantage over its principal in lending to the poor, thus minimizing transaction costs. This, in turn, contributes to the viability and sustainability of lending to the poor. The other approaches are different in terms of the NGO getting replaced by a larger identity which could be a Sec 25 company or a full fledged NBFC, which are gradually becoming more visible structure of MFI lending in India. The study in the previous section has also conclusively proved that they stand a better chance to attain operational sufficiency and also, the impact on poverty is also more pronounced in the NBFC model.

2.1 Qualitative comparison of the legal forms

MFIs Registered under the Societies Act

Advantages

- simple process of registration;
- simple record keeping and even simpler regulations;
- low possibility of interference by the regulator;
- (largely) exemption from tax due to the overtly charitable nature of operations; and
- appropriate for taking up micro-insurance (as an agency) on behalf of insurance companies

Disadvantages

- as a charitable institutional form, in essence inappropriate to the for profit, financially sustainable strategic goal of microfinance operations;
- tax-exemption for surpluses can be (and is) challenged on the question of whether provision of microfinance services is a charitable activity;
- no system of equity investment or ownership, thereby, making it less attractive for commercial investors interested in microfinance;
- commercial investors generally regard the investments in such entities risky primarily on account of their lack of professionalism and managerial practices and are, therefore, reluctant to commit large volumes of funds to such MFIs;

  In accordance with Section 45S of the RBI Act, 1934, no unincorporated bodies are allowed to accept deposits from the public. Organizations registered under the Societies Registration Act and the Trust Act are considered unincorporated bodies. Therefore, according to the law, they are not even allowed to collect savings from their clients; and also vulnerable to the use of 'usurious interest prevention acts' of various state governments, the status of microfinance is debatable as a charitable activity.

Registration under the Indian Trusts Act

The advantages and disadvantages related to MFIs registered under the Societies Act are equally applicable to trusts. However while IRDA recognizes NGOs registered as societies as a distribution channel for the micro-insurance, there is no such clarity with regard to trusts. Apart from this, private trusts may be even more unsuitable as the tax exemption extended to societies may apply to such trusts only to the extent the Income Tax department accepts their activities as being charitable.

Advantages

- simple process of registration;
- simple record-keeping and even simpler regulations;

- low possibility of interference by the regulator; and
- (largely) exemption from tax due to the overtly charitable nature of operations;

Disadvantages

- as a charitable institutional form, in essence inappropriate for the for-profit, financially sustainable strategic goal of microfinance operations;
- tax-exemption for surpluses can be (and is) challenged on the question of whether provision of microfinance services is a charitable activity;
- no system of equity investment or ownership, thereby, making it less attractive for commercial investors interested in microfinance;
- commercial investors generally regard the investments in such entities risky primarily on account of their lack of professionalism and managerial practices and are, therefore, reluctant to commit large volumes of funds to such MFIs;
- In accordance with Section 45S of the RBI Act, 1934, no unincorporated bodies are allowed to accept deposits from the public. Organizations registered under the Societies Registration Act and the Trust Act are considered unincorporated bodies. Therefore, according to the law, they are not even allowed to collect savings from their clients; and
- also vulnerable to the implication under the money lenders (prevention of usurious interest rates) Acts of various state governments as the status of microfinance is debatable as a charitable activity.

Registering MFIs as Section 25 Companies

Section 25 companies are subject to some of the problems similar to those faced by societies and trusts. However they have certain advantages also. These issues are discussed as under:

Advantages

- **Exemption from Income Tax:** Section 25-1A of the Companies Act, 1956, mentions as objectives of charitable Section 25 companies as "the promotion of commerce, art, science, religion, charity or any other useful object". This works as a great advantage for MFIs.
- **Leveraging Capacity:** Having a Section 25 company adds to the legitimacy of the institution. This also adds to the credibility of the commercial FIs who are willing to lend to the sector.
- **Easier processes and low regulator interference:** As discussed in the preceding sub-sections, Section 25 companies have relatively easier processes to register and they need to comply with very few regulatory requirements. They also need not register with RBI unlike NBFCs. This makes the functioning of the organization very easy.

Disadvantages

- **Deposit mobilization:** The same restrictions as for societies/trusts apply to deposit mobilization on Section 25 companies.
- **Not an attractive option for equity mobilization:** Being a not-for-profit entity prohibits the Section 25 companies from distributing dividend, therefore, these entities find it difficult to attract equity investors, even some social investors, to invest equity funds with them. Also the exit route for investors is not smooth since another investor willing to forgo the possibility of a dividend return on the investment must be found.
- **Lack of clarity on ceiling:** Although microfinance defined by RBI provides for financial services of very small amounts, the RBI instructions exempting Section 25 companies from registration and reserve requirements for NBFCs stipulate that loans should not exceed Rs 50,000 for non-housing purposes and Rs 1,25,000 for housing purposes.

Registration as an NBFC

NBFCs are the only type of MFI falling clearly under the purview of the central bank and subject to prudential regulations. As for-profit companies, they need to pay income tax on their lending operations. In the context of the average MFI, some issues that arise in the matter of registering and operating as NBFCs are:

- **Minimum Capital Requirement:** The minimum capital requirement (Rs. 2 crore) for obtaining a license for an NBFC is high. Given the nature of microfinance in India, and the relatively small size of most MFIs, the mobilization of funds of this volume becomes a major challenge. This is further complicated as the promoters of such NBFCs are largely societies that are not allowed to make

equity investments, lest they lose their tax exemption status

- **Deposit Mobilization:** NBFCs are not allowed to mobilize deposits unless they complete two years of operations and then obtain an investment grade rating. Such a rating is doubly difficult to get for MFIs - even those with strong portfolios - since the conventional credit rating agencies designated for this purpose by the RBI regard lending to the poor and lending in rural areas as 'inherently risky'. Yet, given the needs of the poor, deposit services are an important element of microfinance and if the low-income clients are denied this service, the very purpose of microfinance is defeated.
- **Foreign Direct Investment and Venture Capital restrictions:** The entire financial sector is denied access to venture capital investment and was denied access to external commercial borrowings (ECB) until very recently
- Since there are venture capitalists -
- foreign or domestic - willing to put their money into microfinance, any restriction of this sort places an additional handicap for MFIs. Yet, there are an increasing number of socially responsible international investment funds for microfinance and their investments are effectively barred from India. Foreign Direct Investment (FDI) in equity is allowed but must be for a minimum of $0.5 million (Rs. 2.15 crore today) and cannot exceed 50 per cent of the equity of an NBFC. This means that the MFI must first raise more than Rs 2.2 crore from domestic sources before it can become eligible for foreign equity investment.

However registration with RBI as an NBFC offers advantages also. Some of these advantages are listed below:

- **Investor Confidence:** MFIs registered as NBFC because of being recognized and regulated entities for carrying out microfinance operations, provide a higher level of confidence to institutional lenders and banks.
- **Limited Regulation, if not Accepting Deposits:** MFIs registered as NBFCs are subject to nominal regulations if they are not accepting public deposits. Though the general poor clients are deprived of a very important financial service in case deposit acceptance is not allowed. It also brings down the level of regulation significantly if the MFI is not accepting deposits.
- **Attractive Option for Social Investors:** Despite having a very high ceiling for equity investment in NBFCs, they are the most preferred options for social investors interested in the sector. With a regulated structure, NBFCs have a relatively disciplined and professional management. With the equity structure being clearly laid out, the exit route for such investors is also relatively safe compared to other types of MFIs. This factor also helps them in placing their donated equity with the NBFC. Considering the disclosure norms that such NBFCs need to follow on various matters, the willingness of such investors to put their funds increases significantly.
- **Upscaling of Operations:** With a regulated set-up, disciplined and professional management and a high level of investor confidence, it becomes far easier for the MFIs to upscale their operations. The examples of the MFIs who have converted during the last few years into NBFCs clearly point to this.

This part of the study attempts to determine and quantify the components of transaction costs of lending to the poor through the various linkages. More specifically, it aims to address the following issues:

- What are the costs of NGOs/SHGs/Sec 25/NBFC in lending to the poor?
- How do they compare with banks' direct lending to poor individuals?
- Are they able to cover their costs?
- What are key factors affecting transaction costs?
- What can be done to further reduce transaction costs?
- Can lending to the poor be viable and sustainable?
- What measures must be undertaken at both the organizational and national policy level towards the development of a viable and sustainable financial market for the poor?

2.2 Methodology of the study

For the subjects of our study, we focused on the credit programs of the four MFIs which target the poor using SHGs as delivery channels. They are NEED,

CASHPOR, UTKARSH and SHARE. We understand that the process of lending to the poor using self-help groups has several important features which differentiate it from the usual retail lending of banks and even of cooperatives. The significant differences noted include a deliberate focus on the poor, the organising of client/ members into groups, the use of group mutual accountability and peer pressure as a substitute for traditional physical collateral, and lending in very small amounts over relatively short maturities with weekly repayments.

2.3 Performance Analysis of the Selected MFI's for the study

	NEED	CASHPOR	SHARE	UTKARSH
TA	50,85,191	6,20,74,316	57,69,14,660	313,20,00,000
GLP	44,77,674	5,94,61,459	37,65,93,362	235,50,00,000
TE	5,57,749	22,06,952	6,49,77,369	102,65,00,000
DE Ratio	8.12	27.13	7.88	N.A.
ALBpb	143	143	160	N.A.
ALBpb/ GNIpc	13.86	13.81	1547	N.A.
ROA	2.47%	3.99%	550%	2.9%
ROE	23.72%	147.03%	4518%	7.09%
FR/A	21.84%	26.33%	2420%	N.A.
YGP	22.57%	24.44%	3148%	31.8%
FE/A	8.54%	9.79%	918%	N.A.
PLI/A	1.91%	0.14%	030%	1.2%
OE/A	8.92%	11.89%	614%	16.12%
OE/LP	9.92%	11.43%	820%	N.A.
CPB	14	15	13	N.A.
BPSM	190	251	436	N.A.
PAR30	1.96%	0.06%	016%	2.13%
NAB	31,288	4,17,039	23,57,456	3,21,000

Abbreviations: TA: Total Assets, GLP: Gross Loan Portfolio, TE: Total Equity, DE ratio: Debt Equity Ratio, ALBpb: Average loan balance per borrower, ALBpb/ GNIpc: Average loan balance per borrower per gross national income per capita, ROA: Return on Assets, ROE: Return on Equity, FR/A: Financial Revenue/Assets, YGP: Yield on Gross Portfolio, FE/A: Financial Expense/ Assets, PLI/A: Provision for Loan Impairment/Assets, OE/A: Operating Expense/Assets, OE/LP: Operating Expense/Loan Portfolio, CPB: Cost per borrower, BPSM: Borrower per staff member, PAR 30: Portfolio at Risk, NAB: No of active borrowers, N.A. not made available.

2.4 Major Findings of the Study:

- Larger size MFIs continue to be more profitable, which is reflected in their higher Yield on Gross Portfolio, ROA and ROE. Here size is captured by the Gross Loan Portfolio and also by the number of active borrowers. The number of active borrowers basically indicates the breadth of the outreach. It indicates how extensive the coverage of the Financial Inclusion is. So, we can very well conclude that it is the large size NBFC model MFIs which are creating greater outreach, in terms of breadth, which is more desirable.
- We also need to look at the figure on Average loan balance per borrower per Gross national Income per capital. This number indicates the depth of the outreach. Here, the numbers range between 13%-16% across various forms of MFIs If we compare with global standards, Bangladesh MFIs work in the range of 20-30%, whereas in Mexico it is 3-5% and in Brazil, it is 12-18%. The depth basically indicates the degree of poverty of total customers served and the lower it is, the more the customer base is considered poor. We must understand here the trade off involved, the more poor a borrower, the more is the possibility of default but then, we are lending to the bottom of the pyramid where it is actually required.
- Average loan balance per borrower is around $140, slightly higher for bigger ones. That keeps the social objective intact because the International benchmark is approx $400. Indian MFIs have deliberately targeted the poorest segment of the population and that has kept the average size of the loan small. Also, some of the reason why the average loan size is small is also because of the Purchasing power disparity with global experience.
- But, the lower figures on average loan size means that the transaction costs would be higher, which would be reflected and is the subject of debate in the next chapter. This is also reflected in higher interest rates charged to the borrower.
- The Portfolio quality, reflected in Portfolio at Risk, is also better for the larger MFIs but is not exactly bad for the smaller ones. Both the provision for loan impairment and portfolio at risk are well below 2% for all form of MFIs and that's a very

positive trait. Although, this figure has to be seen in the light of the overall working style of the MFIs in India. For example, many MFIs practice weekly collection, which reduces PaR but increases transaction cost.

- The MFIs which are big have higher borrower per staff member resulting in lower operating expense. The larger NBFC MFIs have a more structured operations and therefore their staff can handle more number of borrowers and with the help of IT integration, which is again possible in the bigger MFIs, the average BPSM is high as compared to the smaller ones. What is however, slightly intriguing is the fact that although BPSM is high, the PaR is lower because the logic should be that if more number of borrowers are to be tracked by one staff, chances of default are higher but that's not getting reflected in the numbers.
- Finally, we can conclude that from pure financial sustainability and profitability point of view, the larger the MFI, the better it is.

Determination of Interest Rates

There are three kinds of costs incurred by the formal financial sector, namely (a) cost of funds, (b) operating cost and (c) cost of loan losses. These costs are, however, not the same for all the channels of the institutional banking sector. The commercial banks perform the function of intermediation between those who save and those who borrow. They are, therefore, able to raise funds through deposits from those who save at very low costs, which may range between zero (on demand deposits, better known as current accounts) to eight per cent (on term deposits). Amongst the commercial banks also the public sector banks have lower cost of funds compared to private sector banks as the former have a larger portfolio of demand deposits.

Costs to MFIs

The costs incurred by any financial institution in making loans is made up of three main components (i) Financial Costs (or costs of raising money for making loans), (ii) Operating Expenses (or staff, travel and other administrative costs of servicing the loans) and Risk Costs (or costs of covering for the risk of losing capital on account of the inability of the institution to recover loans whether or not default is wilful).

Financial Cost

The other credit lending institutions like the credit co-operatives and the MFIs may not have sufficient deposits, as the commercial banks to undertake credit activity on their own. They are, therefore, dependent either on refinancing facility from agencies, such as, the NABARD, the SIDBI, or borrowings from the commercial banks (including the RRBs). The respective financial cost involved under each category is as follows :

TABLE 4

Financial Cost to MFI (on a one year loan), 2008-09

	Institution	Rate of Interest/ (on declining balance)
1	NABARD	8-9
	SIDBI	8-9
II	Commercial Banks	
	a Public Sector	12
	b Private Sector	14

Source : NABARD Status of the Microfinance Sector Report, 2009

Funding may be made available to MFIs by the development (SIDBI/NABARD) also by way of subordinated debts, as promoter's/member's capital (or equity/quasi equity) as well as grants from donors. In view of the high set up cost, the development institutions may charge a lower rate of interest to the MFIs in the initial years, which may be raised subsequently once the MFI has matured. Equity other than 'grants' is, obviously, the cheapest of all funds as there is no interest liability and payment of dividend is to be made only when profits have been earned. The financial cost to the MFI will, thus, be the weighted average of all the different kinds of funds.

Operating Cost

Salaries to the field staff of the MFI, moreover, account for the major cost of these institutions. The sustainability of micro-finance at low interest charges thus depends greatly on staff efficiency. In simple terms, efficiency depends on how many clients a staff member is able to deal with. By and large, MFIs in India are able to service some 150-250 clients per staff member. The larger institutions (typically the MFI-NBFC's) are able to service more borrowers per staff member as some economies of sale take effect and also because of a relatively higher level of automation in their processes. The

leading ten MFIs in India in terms of Asset base service some 239 clients per staff member. This amounts to the operating expense ratio (OER) of these institutions declining as the size of portfolio increases. The table/ figure below gives some idea of start up costs of an MFI in India. We can clearly see from the figures below that it is the first three years and a portfolio size of Rs. 1 crore, which are crucial. Beyond this level of operations, operating expenses decline to 20%, and after about Rs. 2.5 crore, it declines to 14-15% of outstanding portfolio. It is here, where we can see that the really large MFIs are able to achieve 10-12% OERs.

TABLE 5

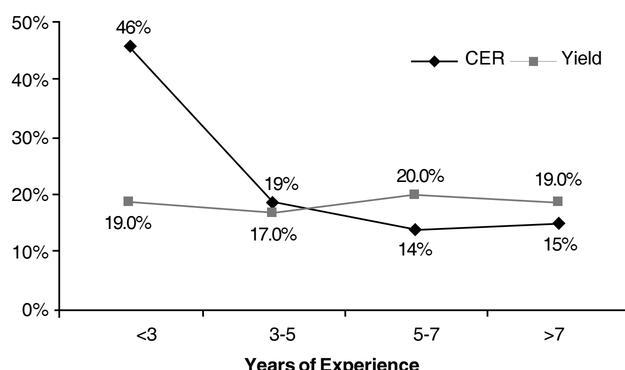
Operating expenses and portfolio yield by age of MFI, (2008-09)

Age (years)	OER	Yield
<3	46.0%	19.0%
3-5	19.0%	17.0%
5-7	14.0%	20%
>7	15.0%	19.0%
M-CRIL India	**18.5%**	**19.1%**
Top 1012.3%	24.8%	

Source : NABARD Status of the Microfinance Sector Report, 2009

TABLE 5

Operating expenses and portfolio yield by age of MFI, (2008-09)



Provision for Loan Losses (risk costs]

Generally, 2 per cent of the loan outstanding is set aside as the normal loan losses in micro-credit and the banking institutions have no option but to load this cost into the lending rate of interest.

Need for 'capitalization'

The interest rate charged on bank credit is also the most important instrument of building 'reserves' through higher profits. A minimum capitalization is considered necessary for building the equity base through retained earnings. This strengthens the capacity of these institutions for both leveraging higher borrowings from lenders/banks as well as to attract more equity due to the ability to pay higher dividends to the shareholders. The interest rates charged by banks or MFIs are linked to the costs incurred in servicing such debts. The final interest rate fixed thus becomes a contribution of all these four components. The Table below provides a general idea of the costs involved in servicing micro-credit, which eventually determines the lending rate of interest.

TABLE 6

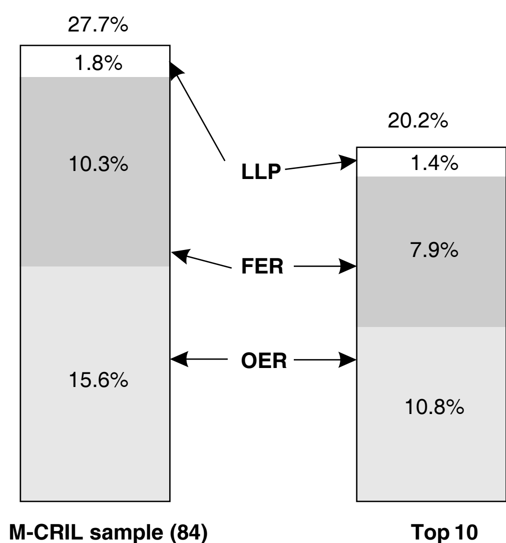
Determinants of Interest Rate Structure for Microfinance in India (on declining balance), 2008-09

Components of the Cost	**Annual Percentage Rate, aprox.** (%)
(*a*) Average Financial Cost of Funds - assuming borrowing at 10-12% but around 70% of on-lending funds comes from borrowings while the rest is from grants or internal generation of surplus or a small amount from "compulsory savings" (or cash collateral)	6-9
(*b*) Operating Expenses	10-14
(*c*) Loan Losses	1-2
(*d*) Desired Capitalization Rate - assuming a 30% growth rate and a capital adequacy ratio of 15%, banks will lend to MFIs if they raise around 45% in the form of "own funds" - part internal resource generation (which is this amount) and part equity finance from SIDBI, NABARD and MF equity funds currently in existence and being established	3-4
Annual Effective Interest Rate	22-26

Source: NABARD Status of the Microfinance Sector Report, 2009

In comparison with the average 3-4% administrative/ operating expenses incurred by commercial banks in India servicing their average borrowers, efficient MFIs incur 10-14%. Compared to the average MFI client who takes loans of around Rs. 56,000 with average outstandings of just over Rs. 3,300, even a relatively small client of a bank has loans of Rs. 35,000-50,000.

The cost differences - as a proportion of the size of the loan - are not surprising though. The internationally recognized rating agency for MFIs, M-CRIL has recently concluded a review of 84 ratings of Indian MFIs undertaken over the past 3 years. A breakup of the costs incurred by all 84 MFIs taken together and also the leading 10 MFIs (Top 10) separately is presented in the figure below. The yield for the large sample is 25% whereas the Top 10 earn 23.9%. The horizontal line shows the yield. What this means is that the average MFI makes a loss whereas the Top 10 (that serve 67% of MFI clients) earn a 3.7% margin which is sufficient to enable roughly 30% growth since this capitalizations enables them to generate around 8 times the amount in debt from banks. On this basis, 24% is a reasonable rate for MFIs to charge from clients since this is what it costs to service the loans and maintain some growth to serve larger proportions of the population. The problem is that the smaller MFIs cannot survive at that rate and would need much cheaper funds - say at 4% to keep their financial expenses (Financial Expense Ratio - FER) down.



(OER= Operating Expense Ratio, FER: Financial Expense Ratio, LLP: Loan loss provision),

Source: M-Cril, 2008-09

Weighted average yield is 25.2% for full sample and 23.9% for Top 10. The 24% cost of micro-lending that efficient MFIs can reasonably charge is well below the costs of informal sector borrowing in all but a very small part of the country and is very much in line with the cost of consumer lending even by the scheduled commercial banks.

Need to charge cost-recovering interest rates

The sustenance and economic viability of MFIs depends on charging of interest at the rate of 21-24%. Sa-Dhan, (an association of MFIs) has laid down Model Mutual Code of Conduct for Micro Finance Institutions. It advocated interest rate of 21-24. Sa-Dhan's model code of interest is based on the following cost :—

TABLE 7

Interest rate schedule for MFIs (2008-09)

Item of cost	Basis of cost	Percentage
Cost of Funds	SBI Prime Lending Rate	**9%**
Cost of delivery of credit	Money order charges by government post office	**5%**
Cost of Collection of payment	Money order charges by government post office	**5%**
Cost of provisioning for bad debts	As per RBI norms, based on extent of bad debts	**1-3%**
Profit margins	Minimum required to maintain capital adequacy as per RBI norms	**1-2%**
Total		**21- 24%**

Source: Sa-Dhan Report on MFI's, 2009

What we must understand here is that the performance of the MFIs cannot be judged purely on the basis of rate of interest. MFIs have numerous other advantages like outreach, delivery and collection of loans, etc, which makes it more attractive than the formal sector. The MFIs deliver and collect consumer loans virtually at the door step of the borrower and at intervals convenient to the borrower. To counter the criticism that the MFIs are charging higher rate of interest, there is an urgent need for creating awareness about the need for charging cost-recovering interest rates. The microfinance institutes reach roughly one fifth of the poor households and small percentage of non-poor households. Sustenance of these institutions and their continued support to the poor households depends on charging cost recovering rate of interest.

TABLE 8

Results of the Comparative Study of the four forms of MFI in India, 2009-10

Parameters	NEED (NGO-MFI)	CASHPOR (Sec 25 Comp)	UTKARSH (small NBFC)	SHARE (large NBFC)
Rate of interest charged on loans	12% (flat)	12% flat	26%	24-28%
Loan processing expenses	1%	Flat Rs. 100 on a 5000 loan	In-built	In-built
Socio-economic background of borrowers	Farmers, artisans, small time shopkeepers etc	Farming, animal husbandry, micro-entrepreneurs etc	Micro-enterprise, Animal Cattle husbandry, Farming etc	Micro-enterprise, Breeding, Farming etc
Purpose wise loaning status	Agriculture/Animal Husbandry (45%), Medical needs & Self consumption (15%), Income generating Activities (25%)	Agriculture/Animal Husbandry (30%), Medical needs & Self consumption (10%), Income generating Activities (50%)	Agriculture/Animal Husbandry (25%), Medical needs & Self consumption (20%), Income generating Activities (45%)	Agriculture/Animal Husbandry (50%), Medical needs & Self consumption (10%), Income generating Activities (35%)
Extra services offered apart from providing loan	Health & Sanitation, Education, Vocational training, organizing vaccination camp, adop-ting villages in School, promoting trade fares etc to sell the handicraft prepared by women borrowers, marketing intervention, Micro-insurance.	Education, Health & Sanitation, only lending to women who send their children to school, Micro-insurance.	Samutkarsh Welfare Service (a section 25 company) formed; Utkarsh will provide the following contribution: (a) Interest Free loan of Rs 5 lac for 36 months for initial set up cost and (b) 0.5% of the Revenue from Oct'10- March 11 and 3% of PBT.	Health Insurance, Credit Life Insurance, Remittance Services, children's education, health, nutrition, non-formal education, adult literacy and sanitation.
Geographical location of borrowers	Lucknow slums, Sitapur & Hardoi	Varanasi rural, Bhadohi, Mirzapur, Chandauli.	Varanasi rural, Jaunpur, Gorakhpur, Basti, Balia	Across 20 states including Andhra Pradesh, Karnataka
Number of active borrowers	32718	4,17,200	53,325	23,58400
Average loan size	6154	6700	6570	8250
Cost per loan	630	670	**NA**	450
Cost per borrower	690	690	**NA**	550

2.6 Major Findings and Conclusions of the Comparative Study

1 The average rate of interest charged is in the range of 22-30%, although majority of the loan is in the range of around 24-26%.

2 Most of the MFIs are very transparent about the loan processing expense and they disclose it explicitly to the borrower at the time of lending. Most of them however have it inbuilt in the overall interest rate structure, few charge it separately but the good thing is that it is not a hidden cost anymore.

3 All the Microfinance Institutions lend to women (almost 99% portfolio) and mostly poor women, who are engaged, either in some small time trading of toiletries, cosmetics and other items of daily use or in some farming activity, animal husbandry, or some handicrafts designing etc. Also, loans are given for medical emergency and for personal consumption on durable goods like TV, Cycle etc which could indirectly boost their current economic activity. Also, it is heartening to see that most of the MFIs don't really encourage consumption loans and the portfolio of loan towards consumption related activities is limited to around 10-15%.

4 Again, most of the MFIs have moved beyond just Micro-credit and do lots of social intervention and community development related activities. The degree to which they intervene differs NEED, for example provides direct market linkages to the handicraft workers (from in and around Lucknow slums, who are expert in Lucknow Chikan work) by organizing Trade Fair at various places and also linking some of these groups with government

buyers like IIMs to give them bulk orders. A bigger MFI like SHARE would not have so direct intervention but still spend lot of money on training the borrowers on the merits of proper education and sanitation. They also create infrastructure facilities for education and sanitation

5 The average loan size varies in the range of Rs. 6000-8500, with larger MFIs giving larger loans. The large size of each loan is advisable because the money should be large enough to help them start some economic activity but also, it should not be too large that it seriously impairs the loan repayment capability of the borrower. Still going by International standards, most of the MFIs in India are giving major part of the loans to the poorest section of the society.

6 Again, going by the cost per loan or cost per borrower, we can clearly see that the cost decreases as and when the MFI becomes large and the benefits of economies of scale start showing their impact. Also, because of increase level of IT integration and more structured processes, the transaction cost is bound to reduce as the MFI scales its operations.

7 Keeping in mind these observations and few other issues highlighted earlier in the, financial analysis, it is a natural trajectory for MFI's to reach to an NBFC status where the demand for funds is not so severe and raising money for further expansion is easily accessible.

8 Most of the funding institutions like SIDBI, NABARD and even commercial banks will lend to an MFI only when it is reasonably big and shows a handsome portfolio of loans outstanding with good repayment record. Therefore funds constraint is a genuine concern for small time MFIs because they need money to scale and get more money from big funders.

9 In terms of creating social impact on the ground, both forms (big and small) do a fair amount of social intervention and the bigger ones are better placed to make a larger impact in terms of reaching out to more number of people and also, in terms of taking default cases on their balance sheet without much impact.

10 Of course, one thing is sure, that when you become very big (say like SHARE), one may become slightly arrogant and lose touch from the actual ground situation. Whereas if you are small and continue to be small, you may not be very efficient in your operations and your profitability may not be all that great (to attract the interest of private equity players or even stock markets) but your head is very close to the ground and chances are that you are making a real impact.

11 So, we conclude here that there is a trade off involved and, the verdict is clearly in favour of the larger MFI's but with a pinch of salt and the regulators must not ignore the contribution of small fries

12 Accordingly, it is also suggested (although not in the purview of the current study) that regulator should not paint the whole industry with a broad brush. It should understand that the smaller MFIs are less efficient and they need to be nurtured for few initial years and once they are big enough, the rules of the game can be applied to them.

13 The smaller MFIs will have higher transaction costs because of higher operating expenses and therefore may charge a slightly higher interest rates initially but once they have scaled up their operation significantly and reached a critical size, capping of interest rates could be a useful technique to curb their profit orientation.

CHAPTER-3

Regulation

In the last few years, microfinance industry changed significantly due to several drivers. First, we are witnessing an increasing degree of professionalization within the industry, often moving from local spontaneous micro lending initiatives to better equipped and organized institutions, characterized for a higher sustainability compared to the past. Second, a large number of global financial intermediaries, for different reasons, are starting to be involved in microfinance, so contributing to modify the landscape of the traditional MFIs. Third, new technologies, and especially the web based platforms for channeling funds directly from households to microfinance institutions and borrowers, can represent an interesting and alternative source of funding for MFIs. These alternatives make it easier to diversify the degree of dependence of such institutions from international donors and expensive funds' providers. Finally, as a consequence of the above-mentioned drivers, it is possible to witness a very significant growth in microfinance business worldwide. Such important progresses of the industry make the role of regulators and supervisors more and more crucial and, therefore, it becomes always more urgent to highlight the key criteria that a country has to follow in order to design an efficient and effective regulatory framework. The recent attention on microfinance industry is also demonstrated by the interest towards this segment of financial market of the Basel Committee on Banking Supervision, which in February 2010 published a consultative document on 'Microfinance activities and the Core Principles for Effective Banking Supervision'. Through such a document, the Basel Committee aims at stressing how the traditional 'Core Principles for Effective Banking Supervision', largely agreed and accepted all over the world, can be adapted and implemented in microfinance business.

Starting from the analysis of the most recent trends in microfinance business, the goal of the chapter is to identify the most suitable regulatory solutions according to some key variables that may draw and characterize the microfinance industry in a country. In this framework, the paper deepens the recent Basel Committee's study, which tries to extend to microfinance a set of core principles for an effective supervision, and it also analyses the practices currently used for regulating and supervising MFIs.

3.1 INTRODUCTION

In the last few years, microfinance industry significantly changed its shape, due to several important factors. First of all, the degree of professionalization of the industry substantially increased worldwide, especially comparing it with simpler microcredit experiences that were predominant since the beginning of this century. Nowadays, beside a huge number of small microcredit institutions, which offer small credits on a local basis, mostly pursuing a social mission, there is an increasing number of bigger and better organized commercial microfinance institutions (MFIs), which supply a wide range of financial services to financially excluded customers, aiming at full sustainability.

Second, the development of new technologies applied to microfinance makes possible for microfinance institutions to achieve several advantages; more specifically, they can optimize their financial management, can increase the set and the quality of services offered and, ultimately, are able to reach a larger number of customers. In this framework, the two most important changes in delivery channels that the microfinance industry is facing are the development of on-line peer-to-peer lending platforms dedicated to microfinance and the development of mobile banking services. Peer-to-peer microfinance on-line platforms allow microfinance institutions to have access to a potential unlimited number of people that have a financial surplus and which could be interested to finance the customers of MFIs having viable investment projects. At the same time, thanks to the web based microfinance platforms, the MFIs are able to diversify their sources of funding, to attract cheaper funds, if compared to the vast majority of the alternative sources of funding, and to reduce the dependence from international donors.

On the other hand, the development of mobile banking services applied to microfinance is generating important advantages in providing basic financial services through a tool - the mobile telephone - that is largely owned also

by the poorest people in developing countries. The collaboration between MFIs and large mobile networks made possible to supply small loans and payment services on a larger scale and in very remote areas, also in favour of those customers that, alternatively, would not easily approach MFIs. Third, a large number of financial intermediaries - including commercial banks, large financial groups and specialized microfinance banks - are more and more involved in microfinance, either directly providing financial services to those who used to be financially excluded or sustaining local MFIs with funds and technical assistance. As a consequence of the above-mentioned factors of change, the size and the complexity of microfinance industry increased, especially in some countries. Therefore, also typical microfinance risks are changing, together with an increasing capability of MFIs to manage them. It is obvious that all these significant transformations have a deep impact on the regulatory framework, which must be adequately equipped to tackle the new challenges.

3.2 THE RATIONALE FOR REGULATING MICROFINANCE

The literature concerning financial regulation affirms that a market must be regulated in the eventuality that it could not achieve an efficient equilibrium autonomous. As known, the goals of regulators are to increase efficiency in capital allocation, to implement effective risk management procedures and to protect less informed parties that enter into a financial contract. These abstract concepts are translated, in all financial systems, in a set of rules concerning the structure of the financial industry itself, the prudential regulation of intermediaries and markets and the level of transparency and disclosure. Moreover, under this complex set of rules, lies the consciousness of the presence of informative asymmetries, due to which in some financial contracts one party has less information than the other one; therefore, in order to preserve the rights of the less informed party and to allow him to take conscious decisions, a supervision on financial system is implemented in all the countries.

As to microfinance, in order to reach effectiveness in relieving poverty by creating a safer environment for economic development, the main goal of microfinance regulators is to ensure the soundness of MFIs and the quality of the services that they provide. Besides these objectives, a peculiar consideration for microfinance institutions concerns their capability to attract donor's and public's funds for financing microfinance; in some contexts the lack of a clear regulatory structure of MFIs - based on preventive and protective instruments - as well as the inadequacy of the general legal environment, determine, ceteris paribus, a difficulty for MFIs located in some countries to attract funds. In presence of appropriate regulatory schemes and of a reasonable supervision on MFIs, a greater amount of money could be addressed to those economic initiatives that, as mentioned before, produce recovery rates higher than the traditional financial sector and can rapidly improve the life conditions of a huge number of people.

First aspect to analyze is the assessment of systemic risk deriving from microfinance. It depends on the development of the industry in the country, on the industry's age and on the volumes intermediated by MFIs in the financial system. Second decisive factor, which orients if and how to regulate MFIs, is the typology of activity carried out by MFIs; particularly, the most sensitive distinction is between credit-only institutions, entities that collect savings, and intermediaries which provide other financial services not included in traditional intermediation. Third criterion to take into account is the origin of funds utilized in order to provide microfinance services. Under this profile, there are different interests to be preserved in case the MFIs use public's sums, donor's funds or member's savings. Last aspect to be considered is the nature of MFIs to somehow regulate, analyzing institutions that have different legal structures, governance, target clients and goals (distinguished, for descriptive reasons, in NGOs, credit unions, microfinance banks and downscaling commercial banks), which must be treated according to various approaches.

As far as the first criterion is concerned, until microfinance used to be a marginal phenomenon that involved a few credit-only NGOs and a small number of beneficiaries, there was no need to think about the opportunity to regulate, because regulation and supervision are expensive public goods. Moreover, in some developing countries, it is more likely that these goods are involved in a host of principal-agent failure such as corruption, which often makes vain any attempt to supervise microfinance institutions. Given their nature of expensive public goods, regulation and supervision should be used in those areas with the highest payoffs in terms of systemic risk mitigation.

According to the literature and to the experiences of the past years, in the vast majority of countries microfinance does not create systemic risk, given the small amount

of loans and the very limited access to the payment system of MFIs, where it exists; therefore, in all the countries where the systemic relevance of microfinance is limited, a vast number of authors agree on a soft regulation, essentially based on public registration (licensing), or suggest the implementation of self-regulation schemes and second-tier regulation (delegated regulation). Also the development of the industry in the country and the volumes intermediated by MFIs in the financial system affect the decision about how to regulate and the instruments to adopt. Particularly, the need to design a specific regulatory framework for microfinance institutions is especially felt in the countries where those institutions are significant actors in the financial market; otherwise, the most common solution that is adopted is to regulate under Banking Law those entities which collect deposits and offer loans, whereas credit-only organizations are often in a shadow area, without any explicit regulation or supervision.

According to second criterion, the choices about regulation and supervision are based on the nature of the activities that are performed by microfinance entities. All the institutions that provide credits as a unique financial service are characterized by a very low contribution to the overall systemic risk. Therefore, they are often not regulated even if some countries require from them transparency standards and the control of unfair practices (so called "conduct of business" reporting). Of course, whenever a MFI does not limit its activity to credit supply, but collects savings, and sometimes offers payment instruments, the institution is almost everywhere forced to be converted in a regulated entity (commonly a bank), or assumes the status of "microfinance bank" where a specific regulation exists. Such conversion, as obvious, implies the respect of all entry requirements, of minimum capital requirements and prudential ratios, as well as of periodical reporting. Last, for those institutions which offer other financial services, it seems appropriate to adopt a regulatory approach similar to credit-only institutions, if the only peculiarity is represented by the lending methodology; on the other hand, for those MFIs which intend to provide more complex financial service than the traditional financial intermediation, a specific regulation is strongly recommended.

Third relevant criterion in order to determine regulatory policy is the origin of funds used by MFIs. Whenever this money is donated by third-party organizations, these usually have appropriate instruments for assessing the MFI they intend to finance; furthermore, in absence of specific regulations, donors can prevent unfair practices by monitoring the selected institutions and requiring from them specific reporting on the use of funds. The policy considerations can vary significantly depending on whether funds are provided by the public or by members of mutual credit entities or savings banks. In this case, the presence of asymmetric information between depositors and MFIs is often adduced as the main reason why regulation and supervision are required. In fact, depositors are exposed to moral hazard due to the risk of savings absorption in the event of MFIs' crises.

As regards the third criterion, in the light of above the most suitable approach of the ideal regulation to adopt must be diversified according to the source of funds. All MFIs, whatever is their source of funding, in order to improve their capability to attract money, should be required to be publicly registered and should produce periodic reporting (including at least credit methodologies, concentration, credit provisioning and write-offs) to be addressed to a specific regulatory body - where microfinance market is a significant portion of the financial system - or to the authority in charge of supervising the financial system in other cases. Those entities which collect public's funds should be compliant with a set of tailor-made rules concerning market entry, minimum capital ratios, organization and deposit insurance. These regulations on one hand should impose milder capital requirements than banks, on the other hand they should delimitate the potential activity, and therefore the risk, that these entities could run.

Last criterion here approached concerns the nature of MFIs, where the distinction usually performed regards non-governmental organizations, credit unions (and other mutual credit entities), downscaling commercial banks and microfinance banks. The most significant aspects to deepen about the nature of MFIs and their regulation are legal structures, the borders of their activities and their internal organization. As mentioned before, as long as NGOs operate as credit-only institutions they need a very limited attention from regulators. However, when NGOs begin to offer savings facilities they are required to assume a different legal status, with a well defined capital in order to calculate prudential ratios and to implement internal control functions. These institutions, therefore, should then be regulated according to their new nature. Credit unions and microfinance banks, considering their deposit-

taking nature, but also their difficulties in raising capital and their goal of sustainability, have to be regulated by a specific set of rules which prescribe less stringent capital requirements and an easier organizational structure than banks. Last, downgrading commercial banks, which by definition are fully regulated banks according to the national "Banking Law", do not seem to need particular requirements if compared to other banks, because they go on performing not only microfinance services; therefore, in most countries they continue to be supervised and regulated as usual banks.

The combination of all the above-mentioned criteria originates a peculiar picture that varies according to the country, and therefore it is not possible to imagine a single regulatory approach suitable for microfinance industries worldwide. The role of the regulator in microfinance development is still an open issue. While some are in favour of a market-directed approach, with the regulator simply setting the framework for the industry, others advocate a more government-directed stance with an active promotional role for the regulator. Still, in some countries, such as India, the role of the regulator is to integrate microfinance into the overall financial infrastructure, which usually requires a degree of promotional support in the early stages of the industry's development; the regulator's support to ensure the soundness of these institutions could involve lending assistance and gradually the introduction of prudential norms.

A deep regulation would contribute to make the microfinance safer (and depositors too), but it would make it too complex for small MFIs to operate in accordance with regulation; the net effect could be a reduction in microfinance supply, which is the consequence that those who support regulation want to avoid. Furthermore, a too strict regulation usually limits the capability to innovate, therefore policy makers deciding which regulation to implement must consider the overall soundness of the financial system, but also innovation.

3.3 CHALLENGES OF MICROFINANCE REGULATION

Regulation of the microfinance sector poses unique challenges. They are worth enumerating as there appears to be inadequate appreciation of these challenges in India. The CGAP (Consultative Group to Assist the Poor), an international consortium of public and private development agencies evolved a set of "Microfinance regulation consensus guidelines" which have been adopted by its donor agencies. These guidelines are general in nature and each country is expected to evolve its own regulatory framework based on considerations of likely effectiveness and cost of supervision. The lending models used in microfinance have peculiarities and hence regulation of microfinance poses certain unique challenges, different from bank regulation.

- First, MFIs may not pose systemic challenges in the sense that it is unlikely that even the largest MFIs are "too big to fail". For example, the asset size of one of the largest MFIs in the country, SKS Microfinance Private Limited in March 2009 was Rs 246 billion while that of the largest private sector bank in the country, ICICI Bank, was around Rs 3793 billion, approximately 154 times as large (wwwicicibankcom and wwwsksindiacom). MFIs, however, deal with low income groups least likely to bear downside risks, in a democratic country, politically the MFIs may be "too sensitive to fail". The implicit contingent liabilities are on the State, making their effective regulation in the interest of the Government.
- Second, in the case of bank regulation, banks are often required to make full provisions for loans without collateral. In the case of MFIs, most loans are collateral free and hence no such measures are possible. On-time repayments on microfinance loans however tend to be high, though experience shows that once a loan is overdue, the ultimate collection of the loan is less likely, than in the case of loans that are backed by collateral (Rosenberg, 2008). As a result, provisioning of already delinquent loans needs to be more aggressive for microcredit loans as compared to other loans.
- Third, while bank failures may be contagious in the sense that the failure of one bank is likely to impact solvency of others due to the interdependent nature of the payments system, the interdependences between group members in microfinance can lead at times to a different kind of contagion effect. Widespread defaults can occur either if some members start consistently defaulting or if there are rumors of MFI failures. An important incentive for repayment of collateral free MFI loans is the ability to obtain larger loans in the future. Any event which makes the possibility

of future loans reduce considerably, has the potential to trigger widespread defaults. A regulator of MFIs has therefore to be highly sensitive to these realities.

- Fourth, MFI customers are often first time users of financial services and usually have low education. The responsibility on the MFI to offer the right products which suit their members' needs as well as provide adequate financial education and training to them is considerable. Regulation needs to necessarily oversee this important element of MFI operations.
- Fifth, merely formulating regulation regarding codes of conduct for MFIs and providing channels for dispute resolution regarding MFI practices is not sufficient. MFI customers need to be made aware of them by using appropriate communication Moreover, the channels need to be easily accessible.
- Sixth, the cost that MFIs would incur in complying with regulation needs to be considered, as it may have an impact on their lending rates.

As in the case of regulation of any financial institution, two basic issues arise in regulating MFIs, prudential and non prudential. The first relates to issues regarding solvency of the institution which is important to maintain confidence in the financial system and protect depositors. The second, non prudential regulation includes all other matters such as guidelines on interest rates, truth-in - lending laws and anti money laundering rules.

The CGAP guidelines on microfinance regulation favour a clear distinction between the supervision of depository (deposit accepting) and non depository MFIs, as the former require closer monitoring. Housing the supervision of non depository MFIs separately would help to avoid confusion and more importantly so as to prevent the public from being misled into believing that the authority is vouching for the financial health of these MFIs when it is not (and should not be) closely monitoring their financial health. The guidelines provide that for deposit taking MFIs, the supervisory body most appropriate would be the authority which supervises commercial banks. This leverages existing supervisory skills and reduces incentive for regulatory arbitrage. The supervisory staff needs however to be trained in the particular portfolio characteristics of MFIs. Another alternative suggested for supervision of MFIs is "delegated supervision" which refers to an arrangement where the Government delegates direct supervision to an outside body while monitoring and controlling the body's work.

Prudential Issues

Some of the main issues include minimum capital limits, capital adequacy requirements and loan loss provisions. A minimum capital limit is usually set which is often used as a rationing device in order to keep the number of MFIs to be supervised within manageable limits (Rosenberg, 2008). Capital adequacy requirements are based on the premise that capital acts as a cushion against possible losses for depositors and creditors. Similarly loan loss provisions are required so as to build reserves to provide for future losses. The peculiarities of MFI portfolios discussed earlier need to be taken into account while setting these requirements.

Non-Prudential Issues

Transaction costs in microfinance typically include cost of group formation, group training and cost of weekly collections at the customer's doorstep. As the value of the loans are typically small, these transaction costs are high on a percentage basis and contribute to higher interest rates as interest rates are a function of risk, cost of funds and transaction costs.

Why is MFI Regulation Necessary?

There is a huge unmet demand for financial services in the micro-enterprise sector. Despite some success stories, MFIs probably reach fewer than 5% of the potential clients. Serving this market will require access to funding far beyond what donors and governments can provide. Thus, many MFIs want to expand their outreach by raising funds from commercial sources, including deposits. Some commercial banks are also looking to extend their financial services into the micro-enterprise market. Most of today's MFIs are significantly different from banks in institutional structure, and the business of managing a micro-loan portfolio differs in important ways from the business of managing a conventional bank portfolio. MFIs and micro-loan portfolios cannot be safely funded from commercial sources, especially public deposits, unless appropriate regulation and supervision regimes are developed.

1.1 KEY ISSUES

1. Interest rate limits

MFIs have much higher costs than conventional banks Legal limits on loan interest rates, if enforced, will

usually make commercially viable microfinance impossible.

2. Who should be regulated?

In most countries 85% of MFIs are not financial intermediaries i.e., they are lenders only, and do not take deposits from the public. There is probably no strong reason for public prudential oversight of such MFIs, since protection of depositors is usually viewed as the principal rationale for such oversight.

3. Financial standards

How stringent should standards for microfinance be? There is no blanket answer to this question: compared to conventional banking business, microfinance will require norms which are stricter in some specific aspects, and more flexible in others.

4. Asset Quality

Microloan portfolios frequently show lower delinquency than normal commercial bank portfolios. At the same time, MFI delinquency tends to be more volatile, especially where management becomes distracted from a consistent focus on repayment performance. Systems to track and respond to delinquency are particularly crucial to MFIs and they should probably provision their overdue loans somewhat more aggressively than conventional banks. On the other hand, conventional portfolio protection measures may not be appropriate for microfinance. For instance, automatic imposition of high provisions on uncollateralized loans would make most microfinance impossible, because most MFI borrowers cannot provide conventional collateral. Additionally, it will be inappropriate to require elaborate loan documentation or involved credit approval procedures because the financial viability of MFIs depends on minimizing the processing cost of their tiny loans. Furthermore, case-by-case loan reviews will be impractical. Regulators will need to be flexible in considering alternatives, such as (a) reliance on historical performance of portfolios, (b) statistical sampling of arrears, or (c) focus on the adequacy of management information systems and policies-including staff incentives-for dealing with arrears.

5. Minimum Capital Requirements

Some theorists of financial regulation downplay the importance of minimum capital requirements as a safety factor, viewing them rather as a rationing device to prevent the supervisory authority from being overwhelmed with more institutions than it can handle. The social importance of encouraging microfinance provides a reasonable argument for fixing lower minimum capital requirements in this arena. On the other hand, regulators must recognize that most MFIs do not have private owners with deep pockets who can be expected to provide rapid infusions of fresh capital in emergencies. This latter circumstance should be considered in fixing capital adequacy norms.

6. Capital Adequacy

There are strong arguments against allowing MFIs to leverage their equity capital as aggressively as commercial banks, for the present at least. In addition to the risk factors mentioned above, two other considerations should be addressed. First, most countries have relatively brief experience with microfinance: in the absence of decades of empirical data about MFI performance, regulators may wish to begin cautiously in fixing leverage ratios. Second, because MFIs operate with relatively high costs and lending rates, a given percentage of non-performing portfolio will decapitalize an MFI faster than it would a commercial bank. Taking all these factors into account, it is normally suggested an initial capital/asset ratio no lower than about 20% for MFIs, subject to downward adjustment as the institution and the industry gain experience.

7. Financial Performance

At present, most MFIs receive direct or implicit subsidies. In evaluating an MFI's capacity to operate profitably with increasing proportions of commercial-cost funding, superintendents must make adjustments which account for the effect of subsidies on historical financial performance.

8. Liquidity Requirements

MFIs are exposed to high levels of liquidity risk. Seasonal factors influence many of their clients; they tend to depend on donors, whose funding can be unpredictable; and their non-donor liabilities tend to be short-term. Depending on the availability of quick liquidity in local financial markets, it may sometimes be prudent to set relatively high liquidity standards for MFIs.

- Some traditional banking rules can't be applied to MFIs. The regulators understand, for example, that it is impossible to ask for more than one page of documentation from a client when granting micro-credit.

- Transparency of financial accounting is no less crucial for MFIs than for banks.
- Superintendencies must develop low-cost methodologies for supervising MFIs. Among the approaches discussed were 1) supervision delegated to outside experts, under superintendency guidelines; 2) self-regulation mechanisms that provide MFI managers with guidelines and incentives to monitor themselves; and 3) entry standards, such as management track record (especially in maintaining low delinquency), demonstrated profitability, and ability to do long-term planning.
- Good regulations are useless unless the superintendency has the authority and capacity to supervise and enforce. Donors should consider support to superintendencies as an important tool in building viable microfinance.

3.4 AREAS OF CONCERN

High rate of interest

An MFI's main objective is to provide poor and low income households with an affordable source of financial services. Interest charged on loans is the main source of income for these institutions and, because they incur huge costs, the rates are correspondingly high. Four key factors determine these rates: the cost of funds, the MFI's operating expenses, loan losses, and profits needed to expand their capital base and fund expected for future growth. Many policy makers question why microfinance interest rates remain high even when MFIs receive concessional funds to finance lending. Although micro lenders receive loan funds at concessional rates, they must cost these funds at market rates when they make decisions about interest rates to ensure the sustainability of the institution's operations. Donors provide concessional funds for a particular usage only for a limited period, as do some governments. However, concessional funds cannot be considered a permanent source of funds for MFIs, and provision must be made through interest rates to sustain the lenders' operations.

Inflation adds to the cost of microfinance funds by eroding micro lenders' equity. Thus, higher inflation rates contribute to higher nominal microcredit interest rates through their effect on the real value of equity. Micro lenders have two kinds of operating costs: personnel and administrative. Because micro lending is still a labor-intensive operation, personnel costs are high. Administrative costs consist mainly of rent, utility charges, transport, office supplies, and depreciation of fixed assets. Making and recovering small loans is costly on a per unit basis. Often loan recovery is executed by staff who visits clients, increasing costs in time taken and transportation used. Poor physical infrastructure-inadequate road networks, transportation, and telecommunication systems- in many countries in which micro lenders operate also increases administrative costs and adds significantly to the cost of microfinance operations.

In many countries in the region, the majority of microcredit is provided by a few leading institutions, and competition among them is mostly on non-price terms. Large-scale commercial banks with access to low-cost funds, low operating costs, extensive branch networks, and vast human and other resources to provide financial services efficiently are presently not significantly involved in microcredit. The lack of participation of such conventional financial institutions in the microcredit market also limits potential competition. Microcredit interest rates are often compared with those charged by both commercial banks and excessively subsidized lending organizations. Such comparisons are inappropriate. Commercial banks most often deal with large loans, and their transaction costs are lower than those of MFIs on a per unit basis. Thus, commercial banks are able to charge lower interest rates than MFIs.

A financial institution receiving large subsidies may charge much lower interest rates than other MFIs. In Bangladesh, the Grameen Bank charges an annual interest rate of 20% (on a reducing-balance basis) on its main credit product. Because this rate was below cost recovery levels, the Grameen Bank incurred losses for many years, and these losses were underwritten by the big subsidies it received. Thus, Grameen Bank's interest rates should not be compared with those of an MFI that has not received similar subsidies. Other inappropriate comparisons of MFI interest rates include those charged by government-owned MFIs or government-sponsored microfinance programs that are often compelled to charge lower-than-cost-recovery interest rates based on political considerations. These comparisons also overlook most of these programs and institutions in general that are unlikely to survive in the long term to serve the poor. Moreover, the poor have to incur unusually high transaction costs to access credit from these sources due to credit rationing systems and rent-seeking practices adopted by their employees. Thus, a

comparison based on nominal interest rates charged by such institutions may be highly misleading.

MULTIPLE LENDING

Some of the Micro Finance Institutions (MFIs) financed by banks or acting as their intermediaries/partners appear to be focusing on relatively better banked areas, including areas covered by the SHG-Bank linkage programme. Competing MFIs were operating in the same area, and trying to reach out to the same set of poor, which resulted in multiple lending and overburdening of rural households. Many MFIs supported by banks were not engaging themselves in capacity building and empowerment of the groups to the desired extent. The MFIs were disbursing loans to the newly formed groups within 10-15 days of their formation, in contrast to the practice obtaining in the SHG - Bank linkage programme which takes about 6-7 months for group formation/nurturing/handholding. As a result, cohesiveness and a sense of purpose were not being built up in the groups formed by these MFIs.

Reasons Client May Borrow From Multiple MFI

- The client's business needs exceed the loan offers by a single microfinance providers (to support growth, or a small business),
- Interest rates may vary across the sector, encouraging clients to go to a second microfinance provider,
- The client's credit needs are not fulfilled by one MFI's product ranges (some MFIs may be only specialized in micro-crop loans, while others may excel in micro-insurance),
- The client may want to use additional microloans for consumption purposes or for an emergency, and
- In case of default, the client can take out a second loan to repay an earlier loan or simply start over after the first microfinance provider refuses to advance another loan due to a tarnished credit history (This only occurs in the presence of information asymmetry about client indebtedness - read about a solution through credit bureaus).

From the MFI's point of view, multiple borrowing partially ensures the first MFI gets its money back (in the form of a loan from the second MFI), which leads to good short-term repayment rates. Plus, these reasons suggest multiple borrowing only a problem if the total debt exceeds the client's repayment capacity, and sometimes, it does. MFIs exacerbate multiple borrowing by 'poaching' clients of other MFIs, which involves visiting borrowers of competing microfinance providers and after gaining access to their credit histories, lure them by offering to promptly upgrade their loan sizes. In the long run, rampant multiple borrowing can lead to "large scale defaults".

OTHER ISSUES

Human Resource (HR) Factors in Microfinance

Compensation policies are often commission-based where loan officers get rewarded for the size and quality of their loan portfolios. The result is that loan officers may avoid proper screening of clients' risk profiles and repayment capacities in order to acquire as many customers as possible in the short-run. When it comes to collection time, high-risk clients may be unable to make payments, so loan officers may resort to aggressive collection methods. Naturally, this increases the worker's stress level and harms the MFI's relationship with the clients, which are detrimental in the long run.

Sales and Marketing Factors

- **Sales:** Driven by high levels of competition and pressure from investors and the government, MFIs end up competing for the same market/ client base and set unreasonable sales targets for loan officers The result is the same as mentioned under 'Human Resource (HR) Factors'.
- **Marketing:** Poor adoption of corporate governance principles can lead to inadequate emphasis on client protection, which impacts the transparency of promotional material used by MFIs. For instance, Bank Comparators (Mexico) markets a rate of 4% per month, but in reality, it is 8925% per month (as of 2008), excluding the impact of compulsory savings. Here's another example of deceptive pricing of microloans (CrediAMIGO, Brazil).

The second factor may lead to multiple borrowing where the client thinks s/he is taking out a second or third loan with better terms (i.e. clients are fooled into believing that the MFI charges lower interest rates).

Risk Management Factors

Again, a lack of corporate governance implementation causes lax credit control and poor debt-collection policies, which send out a signal that it is OK to default (and visit the next MFI for another loan). Government-run MFIs usually suffer from this predicament (as well

as other issues) since their primary objective is social welfare and not necessarily financial sustainability. Yet another result of poor governance is scanty risk management systems (repairable through information systems). In the absence of robust screening processes, costs and benefits (indebtedness levels or repayment capacity) associated with each client are not assessed rigorously by loan officers, who (partly encouraged by their compensation policies, as mentioned earlier) recklessly advance new loans. It makes common sense, therefore, to mesh together these functions (HR, marketing, sales, risk management) in order to prevent a situation from arising where excessive multiple borrowing creates widespread over-indebtedness of clients.

Coercive methods of Recovery

There are reports that MFIs or their employees and agents have used coercive methods of recovery and similar complaints have been made by many of the organizations. Coercive methods of recovery are linked with the issues of multiple lending and over-lending. If these issues are adequately addressed, the need for coercive methods of recovery would also get significantly reduced. The primary responsibility for the prevention of coercive methods of recovery must rest with the MFIs. They have to accept responsibility for the good conduct of their employees and if employees or outsourced workers misbehave or resort to coercive methods of recovery, severe penalties must be levied on the MFIs and their management. If this is done, the management of MFIs, in their own interest, will establish a proper Code of Conduct for field staff and make greater investments in the training and supervision of the field staff to prevent such occurrences. Coercive methods of recovery also surface when the growth of the MFI is faster than its ability to recruit the required staff of the right quality and to provide them adequate training. It also surfaces when the systems of control and inspection are inadequate. These are areas which will have to be monitored by the regulator. It has been suggested that coercive methods of recovery have been encouraged by the practice of enforcing recovery by recovery agents visiting the residence of the borrowers. The Andhra Pradesh Micro Finance Institutions (Regulations of Money Lending) Act, 2010 drafted by the State Government includes a list of actions which constitute "coercive action". This includes "frequenting the house or other place where such person resides or works, or carries on business, or happens to be". It also provides that "all tranches of repayment shall be made by the SHG or its members at the office of the Gram Panchayat or at a public place designated by the District Collectors only".

2. Existing approaches to Microfinance Supervision: International Comparison and lessons to be learnt:

(Borowed from Microfinance Regulation in Seven Countries: A Comparative Study by IRIS Centre, University of Maryland)

An effective system of regulatory norms depends largely on the quality of the agency charged with enforcement - in the microfinance case, the financial regulator or supervisor. This section looks at the approaches taken to supervision in some seven countries. The various alternatives include self-regulation, delegation, and hybrid arrangements. The section looks at various issues including the structure and features of the supervisory body, level and kind of supervision applied to different institutions and activities, and oversight of risk and fund management. Is there a separate system of MFI supervision? The financing of supervision costs is also a concern. How were these issues handled in different cases, and how effectively? The focus is on the broad strategies to avoid overloading central banks and bank supervisors with too many institutions to monitor. Some of the observations in the sample countries are:

2.1 ***Bolivia:*** This case, one of the best-known in the field, illustrates the importance of a patient market-development strategy implemented by a highly capable supervisory agency. The Supervisor allowed experimentation, collected and shared timely market information, and engaged the sector in ongoing dialogue while elaborating its technocratic regulatory approach to microfinance. The latter consisted of setting high standards and gradually bringing MFIs into the regulated sector - with the prospect of increasing their range of services from that point. Both the Supervisor and the sector avoided promotional schemes and subsidies This 'minimalist' market-building approach helped bring about a 20-fold increase microfinance portfolios in the 1990s, and steady downward pressure on interest rates. Having weathered the consumer credit crisis of the late 1990s, the sector enjoys steady growth and a high level of sustainability. The gradual introduction of deposit services in the sector led to an expansion of savings, which now cover some 60% of the overall loan portfolio.

***2.2 Brazil*:** This is a typical case of disappointed expectations resulting from an overcautious and restrictive policy framework overlaid on a relatively underdeveloped sector. Even with usury law exemptions, the two authorized MFI forms are credit-only and on top of that, the dominance of government financing sources brings with it subsidized loan capital and interest rate limits - and with this, a lack of progress towards sustainability in the sector. However, the growth of commercial microfinance offers a sign of hope. A more positive development is the expansion of bank involvement in microfinance, which can bring about a more sustained increase in services due to cross-subsidization of different client groups and advantages in risk management. This development may have been helped along by Brazil's policies on banking correspondents and simplified accounts. Still, overall microfinance growth has been painfully slow.

***2.3 Ghana*:** Here is a quite distinct case, illustrating the differences between Africa and other regions. Ghana has a highly active small enterprise sector, with the bulk of assets held informally. Yet, the financial system is extremely shallow. It is further disadvantaged by severe limits on governmental capacity, including in the central bank. Thus, Ghana's early forays into microfinance policymaking were unsuccessful. In particular, the framework for rural banking led to rapid entry and expansion that brought large numbers of small institutions under Bank of Ghana supervision - far outstripping its available capacity. Further, BOG had apparently no interest in sharing supervisory authority. These factors inevitably led to the failure and restructuring in the sector, aimed at tightening the entry policy and prudential standards. More recently, having restored order to the sector, the BOG issued new rules that reflect greater understanding of the sector and that may provide for growth with discipline.

***2.4 Indonesia*:** This is another celebrated case, a microfinance sector with some 44 million depositors, 30 million borrower, and US $141 billion in assets. Indonesia has a diversified microfinance sector with a wide array of providers - from village banks (BKDs) to local microfinance banks (LDKPs) and rural banks (BPRs). There have been some weaknesses in governance and oversight in these sectors, but since the early 1990s, Indonesia has been addressing these by harmonizing standards and delegating supervision while building mainline supervision capacity. This dispersed and decentralized system provides deep outreach to the most distant communities and to the poor (if not the poorest). Current efforts focus on continued harmonization of standards for BKDs and LDKPs, consolidation of the latter, and elaboration of a microfinance strategy highlighting NGO providers - which have hitherto been of marginal importance.

***2.5 Mexico*:** This is an intermediate case, one where there are growth trends and promising regulatory developments that have not yet reached fruition. Mexican microfinance has taken a range of forms, predominantly financial cooperatives (savings and loan coops, credit unions, and others), but also small credit-only finance companies and NGO-MFIs. In 2001, government and advocates from the sector launched a high-profile policy initiative that shortly led to a law (the LACP), and then to a complex implementation process that continues to date. The law provides a set of uniform 'functional' norms for deposit-taking MFIs (popular savings and credit institutions) that can have corporate or cooperative structure. Much of the regulatory system is in place, although work is ongoing. The sector has seen 20% growth during this period of policy development, with total assets estimated at US $22 billion and the client base at 3 million.

***2.6 The Philippines*:** In this case, there is again a diverse array of microfinance providers including rural banks, NGOs, and a range of NBFIs. The challenge here has been to counteract a previous policy emphasis on state intervention through heavy regulation and subsidized credit provision. Since the mid-1990s, the Philippines has articulated a microfinance policy and enacted an amended banking law enabling MFIs to take deposits and to set the terms of their financial services independently (among other things). A number of agencies have stepped in to push forward the processes of market development and strengthening of sectoral governance. This includes the BSP (the central bank), which has played a lead role in tailoring certain regulatory norms to support MFI operations, providing market infrastructure, and, very importantly, building sufficient internal supervisory capacity to deal effectively with the sector. BSP has also delegated some responsibilities, notably putting the credit unions under the supervision of their apex institution, and less formally encouraging standard-setting and creditor oversight of the NGO-MFIs. Through all this, the Philippines has developed a market with some 15 million clients and US $1.3 billion in loans - with relatively low barriers to entry, and notably without a specific law on microfinance.

***2.7 South Africa*:** This is perhaps the most unusual case in the sector. In the run-up to majority rule in the early 1990s, South Africa decided to legalize the existing informal money lending industry, which was growing rapidly, under an exemption to the usury limit. This led to even more explosive growth, with attendant problems of abusive practices, over-indebtedness, and a widespread perception that the sector was overcharging and failing to meet the investment needs of the majority population. In response, South Africa in 1999 revised the usury exemption and made its application subject to compliance with stringent regulatory standards applied by a new Microfinance Regulatory Council. The MFRC has been an active (non-prudential) regulator, pushing the limits of its jurisdiction in the interest of helping develop a sound market through the strict application of standards. Among its areas of activity are registering new microlenders, pursuing unregistered lenders, enforcing consumer protection rules, addressing over-indebtedness, and setting-up and running a National Loan Registry. The MFRC has also played a major role in information, research, and policy advocacy. Partly as a result of its efforts, South Africa is now considering a new legislative framework providing for a higher-profile credit regulator, consumer credit standards that apply to all financial transactions, and a new law on narrow banks to serve the lower end of the market. Under these policies and the MFRC's stewardship, South Africa has developed a microlending market comprised of some 5.5 million loan accounts and US $3 billion in outstanding loans

3. Current Regulatory Structure in India

The two main models of microfinance in the country are the SHG Model, which is implemented through banks which are regulated by the RBI and in the MFI model, while NBFCs are regulated by RBI, societies, trusts, not-for-profit companies and cooperatives are not. An example of the effect of differential regulation is the usurious interest prevention Acts of state governments (such as Tamil Nadu Money Lenders Act,1957 and Kerala Money Lenders Act, 1958) which are not applicable to banks as they fall under the purview of the RBI Act, but are applicable to MFIs which are registered as societies and trusts. In March, 2007, the draft Micro financial Sector (Regulation and Development) Bill, 2007 was introduced in the Indian Parliament to promote and regulate MFOs (microfinance organizations). The definition of MFOs specifically included societies, trusts and cooperatives. The Bill designates NABARD as the regulator for the sector. Microfinance services are defined to include credit, life insurance, general insurance and pension services. While microcredit has been defined as loans not exceeding Rs. 50,000 (Rs. 1,50,000 in case of housing), the other services have not been defined further. The draft Bill was subsequently referred to a Parliamentary Standing Committee, though no recommendations have been given by it and the Bill has lapsed.

LEGAL FORMS OF MFI

(1) Society under Societies Registration Act, 1860 (Registrar of Societies in each state)

Advantages:

- Simple requirements
- Low possibility of interference by regulator
- Tax exemption for charitable activities
- Have been permitted to act as agents for micro insurance by IRDA

Disadvantages:

- No system for equity investment or ownership so unattractive for commercial investors
- Not permitted to accept deposits from customers
- Vulnerable to the use of 'usurious interest prevention Acts' of various state governments

(2) Trusts under Indian Trusts Act, 1882 (No specific regulator)

Advantages:

- Simple requirements and low possibility of interference by regulator
- Tax exemption for charitable activities

Disadvantages:

- No system for equity investment or ownership so unattractive for commercial investors
- Not permitted to accept deposits from customers
- Vulnerable to the use of 'usurious interest prevention Acts' of various state governments.

(3) Not for profit Companies under Section 25 of the Companies Act, 1956 (Company Law Board)

Advantages

- Simple procedures and low regulator interference
- Has several exemptions from requirements of Companies Act
- Can take up the activity of microfinance lending without the permission of RBI

- Can obtain income tax exemption
- Have been permitted to act as agents for micro insurance by IRDA

Disadvantages

- Not permitted to accept deposits from customers
- Not attractive to commercial investors as not permitted to distribute dividend

(4) Non banking finance companies (NBFCs) (Reserve Bank of India)

Advantages

- As they are regulated by RBI, investor confidence tends to be high
- Attractive for investors as exit options are possible

Disadvantages

- Minimum capital requirements of Rs. 20 million
- Not permitted to raise deposits unless they complete 2 years and obtain investment grade rating; the latter condition is difficult to fulfil for MFIs

(5) Urban cooperative banks (Registrar of Cooperative Societies and RBI)

Advantages

- Can be formed with 3000 members and capital of Rs 1,00,000
- Can accept member deposits

Disadvantages

- Licenses no longer being given due to past problems with UCBs
- Dual regulation
- Poor public image

(6) Cooperatives under various state Acts on Mutually Aided Cooperative Societies (No regulation)

Advantages

- Simple procedures
- Can accept deposits
- Can raise equity from members

Disadvantages

- Lack of regulation makes it difficult to attract funds
- No tax exemption

4.1 FEATURES OF THE DRAFT BILL

The Bill, on close analysis reveals that it has at least three positive features:

- First, the Bill permitted Microfinance Organizations (MFOs) to register with NABARD and accept savings from members subject to their meeting the following conditions: it should have been in existence for at least three years, it should have net owned funds of at least Rs. 0.5 million and it should have satisfactory management.
- Secondly, the Bill provided for mandatory registration and periodic report submission (including annual audited reports) by all MFOs, seeking to accept deposits. This has the potential to build a robust database of the sector over time; and help institute greater professionalism in the functioning of the MFOs
- Thirdly, it provided for inspection of MFOs by the regulatory authorities in case of complaints and a dispute resolution mechanism. These steps could serve as important consumer protection steps in the microfinance sector.

Limitations of the Bill

However, there are several provisions in the Bill which, however, merit reconsideration

- First, the Bill designated NABARD as the regulator. As mentioned earlier, NABARD is an active participant in the SHG Model. It has also in 2007, announced plans to promote an MFI jointly with commercial banks. The regulatory role will strengthen its role relative to other participants in the sector. This situation may not be beneficial for the promotion of contestability in the sector and also for the customers who stand to gain if there is healthy competition in the sector. Further, NABARD is already a regulator for Regional Rural banks (RRBs) and cooperatives and hence there are concerns that NABARD's regulatory capacity may be over stretched. Limited success of the RRBs and of the imperatives also raises concerns about NABARD's effectiveness. There are also concerns that NABARD lacks expertise to regulate and develop MFOs in the urban sector as its role has been confined to rural areas and to agriculture. Urban microfinance is potentially a high growth segment which needs appropriate development.
- Second, the Bill did not include in its scope NBFCs and not-for-profit companies. In terms of client outreach, 10% of the total number of MFIs, accounted for 76% of all customers. Many of these large MFIs were NBFCs and so were not

covered by the Bill. As a basic general principle, regulation should be uniform across all institutional forms so as to discourage regulatory arbitrage. This involves structuring operations in such a manner that the organization comes under the jurisdiction of a weaker regulator.

- Third, the prudential norms prescribed for the deposits collected by MFOs are inadequate. The Bill introduced a single safeguard for savings which is the requirement that MFOs offering thrift need to create a reserve fund into which they should deposit 15% of their net profit before dividend every year. The use of reserve fund as the single prudential norm has severe limitations. An MFO not making profit need not form the reserve fund, leaving no safety net for the depositors, even though the need is greater. Further the reserve mechanism covered only savings collected through the group mechanism. But dynamically one may expect MFOs to start offering individual loans and collect individual savings. The requirements of protection of these savings also need to be addressed.
- The fourth serious concern is that the Bill did not specify a prudential limit on the volume of deposits that an MFO can accept. The volume of deposits accepted by the MFO should be linked with its reserve fund or its capital. This anomaly may encourage misuse of NABARD registration, to mislead customers into believing that the Government was guaranteeing these savings.
- A fifth area is that promotion of financial education, which is essential for development of this sector has not been specifically addressed by the Bill. Though MFIs provide some basic training to members, financial education by independent outside agencies would help MFI customers make more informed choices with regard to financial products.

5. MALEGAM COMMITTEE REPORT

Summary of Key Recommendations

1. NBFC-MFI: The sub committee recommended that a separate category be created for NBFCs operating in the Microfinance sector, such NBFCs being designated as NBFC-MFI. The Sub-Committee recommends that a NBFC-MFI may be defined as :

> *"A company (other than a company licensed under Section 25 of the Companies Act, 1956) which provides financial services pre-dominantly to low-income borrowers with loans of small amounts, for short-terms, on unsecured basis, mainly for income-generating activities, with repayment schedules which are more frequent than those normally stipulated by commercial banks and which further conforms to the regulations specified in that behalf".*

2. NBFC has to satisfy certain conditions (Non-Negotiable) It recommended that a NBFC classified as a NBFC-MFI should satisfy the following conditions:

(*a*) Not less than 90% of its total assets (other than cash and bank balances and money market instruments) are in the nature of "qualifying assets"

(*b*) For the purpose of (a) above, a "qualifying asset" shall mean a loan which satisfies the following criteria:-

1 The loan is given to a borrower who is a member of a household whose annual income does not exceed Rs. 50,000;

2 The amount of the loan does not exceed Rs. 25,000 and the total outstanding indebtedness of the borrower including this loan also does not exceed Rs. 25,000;

3 The tenure of the loan is not less than 12 months where the loan amount does not exceed Rs. 15,000 and 24 months in other cases with a right to the borrower of prepayment without penalty in all cases;

4 The loan is without collateral;

5 The aggregate amount of loans given for income generation purposes is not less than 75% of the total loans given by the MFIs;

6 The loan is repayable by weekly, fortnightly or monthly instalments at the choice of the borrower.

(c) The income it derives from other services is in accordance with the regulation specified in that behalf.

5.1 AREAS OF CONCERN

In particular, in the Indian context, specific areas of concern have been identified: These are:

a. unjustified high rates of interest

b. lack of transparency in interest rates and other charges

c. Multiple lending

d. upfront collection of security deposits

e. over-borrowing

f. ghost borrowers

g. coercive methods of recovery

The following recommendations were made with regard to some of areas of concern...

3. Measures (Including Margin Caps) Related to Pricing Aspects...

It is recommended that there should be a "margin cap" of 10% in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of Rs. 100 crores and a "margin cap" of 12% in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of an amount not exceeding Rs. 100 crores. There should also be a cap of 24% on individual loans.

4. Ensuring Transparency in Interest Charges...

It is recommended that:-

a. There should be only three components in the pricing of the loan, namely (i) a processing fee, not exceeding 1% of the gross loan amount (ii) the interest charge and (iii) the insurance premium.

b. Only the actual cost of insurance should be recovered and no administrative charges should be levied.

c. Every MFI should provide to the borrower a loan card which (i) shows the effective rate of interest (ii) the other terms and conditions attached to the loan (iii) information which adequately identifies the borrower and (iv) acknowledgements by the MFI of payments of instalments received and the final discharge. The Card should show this information in the local language understood by the borrower.

d. The effective rate of interest charged by the MFI should be prominently displayed in all its offices and in the literature issued by it and on its website.

e. There should be adequate regulations regarding the manner in which insurance premium is computed and collected and policy proceeds disposed off.

f. There should not be any recovery of security deposit. Security deposits already collected should be returned.

g. There should be a standard form of loan agreement.

5. Dealing with Multiple-lending, Over-borrowing and Ghost-borrowers

It is recommended that:-

a. MFIs should lend to an individual borrower only as a member of a JLG and should have the responsibility of ensuring that the borrower is not a member of another JLG.

b. A borrower cannot be a member of more than one SHG/JLG.

c. Not more than two MFIs should lend to the same borrower.

d. There must be a minimum period of moratorium between the grant of the loan and the commencement of its repayment.

e. Recovery of loan given in violation of the regulations should be deferred till all prior existing loans are fully repaid.

f. It is therefore recommended that all sanctioning and disbursement of loans should be done only at a central location and more than one individual should be involved in this function. In addition, there should be close supervision of the disbursement function.

6. Measures against Coercive Methods of Recovery

It is recommended that:–

a. The responsibility to ensure that coercive methods of recovery are not used, should rest with the MFIs and they and their managements should be subject to severe penalties if such methods are used.

b. The regulator should monitor whether MFIs have a proper Code of Conduct and proper systems for recruitment, training and supervision of field staff to ensure the prevention of coercive methods of recovery.

c. Field staff should not be allowed to make recovery at the place of residence or work of the borrower and all recoveries should only be made at the Group level at a central place to be designated.

d. MFIs should consider the experience of banks that faced similar problems in relation to retail loans in the past and profit by that experience.

e. Each MFI must establish a proper Grievance Redressal Procedure.

f. The institution of independent Ombudsmen should be examined and based on such examination, an

appropriate mechanism may be recommended by RBI to lead banks.

5.2 Critical Analysis of the MALEGAM COMMITTEE recommendations:

1. Separate category for NBFCs operating in Microfinance sector such as NBFC-MFI.

This is an important step towards formulating uniformity to the companies operating in the Microfinance space. It also provides the distinct identity for them.

2. Priority Sector Status to continue

This will help MFIs to raise fund from banks, since under banking norms banks are under compulsion to meet targets of priority sector lending. This ensures flow of funds to MFIs.

3. NBFC-MFI should have a minimum Net worth of Rs. 15 Crore

Currently an MFI being a NBFC is required to have a minimum capital of Rs. 2 crores. Increasing the Net worth will restrict the new entrants in MFI Sector to serious players. While at the same time, how the MFIs will meet this criterion is a concern. Most of the upcoming MFIs have grown out of Non profit oriented Societies/ Trusts etc., who would not have the long pockets to increase the capital base. On the other hand, capping the interest rate/profit margins is bound to drive away a lot of PE funds, who had just developed a liking for the sector. There is clearly a conflict between this provision and the Committee's intention that microfinance be undertaken by socially minded professionals. Such a large amount of start up capital is generally not available to this class of people. This provision effectively closes the door on new entrants with a social purpose and becomes an invitation to commercially minded large companies to enter the business. The net result would be a totally commercial approach to microfinance with no social or developmental intent. The removal of smaller NBFCs from the industry would both cause a setback to microfinance in both the less well served areas of the country and would also reduce competition, strengthening the existing tendency to oligopoly. **The recommendation does not conform to the spirit of financial inclusion.**

4. Funding of MFIs - Creation of one or more "Domestic Social Capital Funds"

This can be considered as new source of finance for the MFIs and will also help the small and upcoming MFIs to start the micro finance operation. This may also create distinct identity for Social Oriented MFIs. Though it sounds good on paper, how this will actually fructify remains to be seen. The broad intent of the committee seems to be fairly clear - High profit seeking PE funds need not dabble in the sector, whereas Social capital (who will typically have lower return expectations and more emphasis on the noble objective of poverty alleviation) be channelized on a larger scale.

5. Restriction on individual lending upto Rs. 25000 and interest rate cap of 24%

The committee has suggested limit on the loan provided to the individual upto Rs. 25000 and also that the total indebtedness of the individual borrower should not exceed Rs. 25000. This limit will not only restrict the access or availability of credit facility to individual microfinance customer but will also curtail his economic development. If microfinance borrowers today take 3-4 loans each from different MFIs, it is because their financial needs are not fulfilled by the loan size restraints of individual MFIs. Borrowing to the extent of Rs. 30-40,000 found in areas like Kolar and other districts of southern Karnataka indicates that this is the level needed by many microfinance borrowers. The key is not the loan size but the loan appraisal. Routine disbursements of Rs. 12,000 each by 3-4 MFIs to a single client vitiate the credit environment in that there is no loan appraisal, only a loosely applied group guarantee. The same overall amount provided by a single MFI would need a proper loan appraisal resulting in a better assessment of customer needs.

A loan size cap is further complicated by the fact that client needs differ in different parts of the country; a Rs. 7,000 monthly income in Mumbai may well be less in real terms than a Rs. 4,000 monthly income in Jharkhand. The needs of microfinance borrowers in each region would also be different. In this age of computers, it would not be so difficult to fix a loan size cap at, say, Rs. 25,000 in the poorest state, Bihar, while using state rural and urban per capita incomes to revise it upwards for other states with a special dispensation for the top 15 cities in the country. These numbers could be index linked to the consumer price index for agricultural labour for rural areas and for urban manual workers for urban areas. Once a year revision would be sufficient to ensure that MFIs adequately address clients' needs.

Further the cap of 24% interest rate will hit hard to those MFIs who are working in very remote area and where the cost of operation is on a higher side. The Micro

Finance business is extremely region specific. The cost of operation may vary across different states as well as geographical conditions. Generally, the cost of operations is much higher in hilly and inaccessible regions. Not coincidentally, the need for micro finance in these areas is most urgent and intense. The committee has laid stress on putting the interest rate cap of 24%. It would have been preferable that this was accompanied with an assurance of subsidized interest rate. The committe has backed up the priority sector status and also hoped for lower interest rates without firmly prescribing the same. Special concessions to Micro Finance sector (apart from the priority sector status) would have reassured the sector that the Government does consider it as a powerful means of poverty alleviation. All over the world, pricing caps have become discredited as a means of consumer protection. India's own experience shows that such caps result in no more than credit rationing leading to increasing financial exclusion of the small customer who is more costly to serve. We know that commercial banks never lent to the poor because of pricing caps. It would be ironical if within a year of RBI removing interest rate caps on priority sector loans, the caps were to be re-introduced for MFIs. Even commercial banks, have 24-30% interest rates on small size personal loans even though they do not provide the convenience of doorstep collection and loan amounts are usually above Rs. 25,000.

6. **Transparency In interest Charges - Only three components in pricing of loan a) Processing fees not exceeding 1% of the gross loan amount b) interest charges c) insurance premium**

This will ensure uniformity among all microfinance providers and also restricts those MFIs who unnecessarily charge high processing fees and administrative charges.

7. Malegam panel suggests limiting margins cap at 10% for MFIs with a loan portfolio of Rs.100 crore and at 12% for smaller MFIs.

This recommendation is strongly questioned on the point as the committee member has made no difference in the operating cost of MFIs across the states in India. There are MFIs who work in the hilly and remote area and for them the cost of operation is pretty high. Considering the example of North Eastern India where the cost of operation for MFIs is on higher side due to socio-economic situation in the states especially in remote areas, where there is inadequate infrastructure, poor connectivity and diverse population spread. Such initiative will restrict the upcoming and existing MFI to enter or expand into these areas.

8. Definition of microfinance clients as those with annual income of less than Rs. 50,000 - *will exclude large numbers of low income families.*

According to NSSO survey data, and allowing for inflation, this measure limits the outreach of microfinance to 50% of the population in rural areas and 20% in urban areas at 2008-09 prices.

At March 2011 prices, with food inflation running at 15-20% over the past few months, this brings the proportion of population likely to be covered by the definition down to about 45% and 18% at best. Yet, we know from estimates by organisations such as the World Bank that the level of financial exclusion in India is of the order of 60%. What then, is to happen to the 20% or more of the population that is classified as non-poor but is still financially excluded? Recent research, and not just in India, has conclusively established that microfinance provides its greatest service in facilitating the lives of the financially excluded non-poor and the upper layer of poor just below the poverty line. The poorest sections of the population are widely believed to need asset transfers and extensive hand-holding to raise their incomes closer to the poverty line. With inflation always an uncertain factor in economic policy making, it would be far better to classify microfinance by loan size, index linked to consumer price indices.

6. Customer protection and recovery only at Centres, not at home or workplace -***unnecessarily micro-manages a business relationship***

This recommendation goes against the interests of both the MFI and the borrower. Doorstep collection is one of the key facilities that the MFI offers to a low income customer. To confine microfinance to collection centres is to negate this benefit for the customer. It will only hamper the business model and retard financial inclusion. The issue in collections is not the collection venue, it is over indebtedness; the committee has made sensible suggestions on the implementation of codes of conduct, grievance redressal and establishment of ombudsmen. It is important for customer protection that Industry Associations and the Bankers Forum play a more proactive role to ensure that MFIs are being socially responsible. Not visiting clients at odd hours is already part of the RBI guidelines for banks and NBFCs **Regulation and codes of conduct should focus on**

these consumer protection measures not micro-management of the business relationship between borrower and MFI. As an additional measure, MFIs could be required to conduct annual independent Customer Satisfaction Surveys through well known social/qualitative research agencies with the report to be published on their websites and submitted to the RBI.

7. Loan tenure *vis-a-vis* loan amount - *affects the business model*

This is again a case of micro-management and affects the business relationship between the lender and borrower; what if a borrower needs a four month loan? Most loans in the more developed urban microfinance market in Latin America have four month tenure. **Regulation should focus on transparency of communication so that a conscious choice of loan size, loan tenure and other loan conditions is made by the borrower.** It should not mandate the business relationship.

8. 75% of loans for productive purposes

It is a simple law of economics: money is fungible, it is impossible to monitor this condition. It should, therefore, be dropped.

9. Centralized loan sanction and disbursement

No significant purpose is served by this condition. The key to good lending is to provide an adequate loan size based on good loan appraisals.

FINAL COMMENTS

First of all, it is a narrowly focused report looking at only a particular set of institutions i.e. NBFC-MFIs. In that sense the broader sectoral needs and challenges are not adequately addressed making RBI take a fragmented view. There are many paradoxes in the Committee's approach and recommendations given the prevailing economic scenario. The first paradox is the use of excessive regulation in a relatively liberalized scenario. The new NBFC-MFIs created have been prescribed with very strict and high prudential and other norms. Not only these norms preclude easy entry of interested players, especially from civil society background but have a potential to drive the MFIs to become more commercial. A major paradox here, given the argument that credit-only MFIs need not be regulated, RBI would be very meticulously regulating these credit-only NBFC-MFIs. If savings is not going to be included, what is the whole rationale for such excessive regulation of this new category of MFIs created?

The Committee seems to be using regulatory norms to address the abusive practices being adopted by MFIs including charging high interest rate. If the concern is mainly one of reducing such practices and not ensuring savings services by these NBFC-MFIs, the solution should have been to go into the causes of those practices per se than to recommend such excessive regulatory norms for institutions which are supposed to serve the poor. In other words the Committee has recommended full-fledged regulated measures for fragmented services by the designated MFIs. It is not sure how far these regulatory norms will help to overcome the key concerns, given several challenges being faced by these MFIs. No doubt the interest rates of MFIs are a matter of concern but the MFIs should be enabled to offer affordable services. The suggestion of the Committee here is to put a cap or ceiling on interest rate, which is a paradox again. When RBI says that it is following a liberalized interest rate regime, such prescription goes against the declared policy unless the MFIs are given adequate concessions or cheaper fund facilities to overcome the cost constraint. How far the RBI will be able to ensure this ceiling in true letter and spirit is a major question.

Coming specifically to the cap, the Committee says that it has worked out a normative cost basis to arrive at such a cap. In this framework, return on equity is also a normative component as per the Committee which is actually a mechanism to drive these MFIs into the hands of commercial players who are also to be blamed for the existing problems. Moreover, the basis of cost worked on an average level ignores the difficulties that could emerge due to wide variations across MFIs. The prescription of double cap (margin and absolute) is likely to create more hassles in the implementation. The MFIs on lower side of cap can continue to charge higher permissible level. Further, who will monitor and authenticate the actual costs of MFIs. Is that the role expected of any regulator? Again, in a declared market driven economy, the regulator meticulously monitoring the cost of a financial firm including penalizing them for any price violation is an incongruity. The Committee here comes out too naive in terms of its understanding of the underlying causes and its remedies. A major cause of the higher interest rate charged by MFIs is due to their inability to tap cheaper funds like banks Having fully denied savings services by these MFIs, no attempt is made by the Committee to address this structural issue.

There should have been clear recommendation to provide relatively cheaper refinance to these MFIs by NABARD and other public agencies as they are trying to address a crucial developmental challenge of financial inclusion. This would have helped MFIs to access cheaper funds from public sources instead from commercial sources. The absence of such mechanism is the main reason why MFIs look towards costly and commercial sources to augment funds. The Committee has only tried to fix rate of interest and not fix this basic problem. There is a suggestion of creation of social capital fund, to augment MFI funds. In a commercialized world when MFIs are trying to offer IPO, one can imagine the scope for any such social funds to flow in a significant way. The Committee hence has given a kind of green signal for MFIs to go more commercial and market oriented.

For compliance on regulator norms and code of conduct, the Committee is emphasizing on the role of industry associations which have to come up in competitive way to be assigned the role. How far self regulation, in market driven environment would work is nay body's guess. At the same time, a RBI committee in way is admitting the inability of RBI as state institution to ensure orderly and sound working of the MFIs. For a more fundamental cure, the Committee could have recommended creation of a full-fledged MFIs- a kind of micro-banks with ability to mobilize savings and overcome structural constraints. With the RRBs having been converted as regular banks, literally there is a greater vacuum in the public sphere for the poor. Instead of such fundamental solution, the Committee has gone in for those which are unrealistic besides being contradictory. The Committee has recommended that NBFC-MFIs be exempted from money lending Acts as RBI is going to regulate them. What if the regulation fails to ensure desirable changes? This was the reason which had compelled states like AP to explore their own regulatory measures for MFIs. The state including RBI has failed to play the expected role in ensuring orderly growth of MF sector through its vacillation and lack of proactive regulatory framework for the MF sector. Now through excessive regulation of a particular set of MFIs, the Committee hopes RBI would help overcome its past failure.

6. PROPOSED MODEL FOR REGULATION OF MICROFINANCE IN INDIA

It is only recently that most countries have started seriously addressing microfinance regulation. Hence the possibility of learning from the experience of other countries is limited. A few examples from countries where microfinance sector has a reasonable history are however taken into account in the final suggested framework for India. An early model of regulation developed in Indonesia involved the central bank as the regulator, with delegation of supervision to a Government owned bank, Bank Rakyat Indonesia (BRI) and some provincial banks. In the Philippines, performance standards have been developed in a collaborative manner by stakeholders in the sector, including representatives from Government, private sector as well as wholesale and retail MFIs. These standards are meant for use as industry benchmarks for all types of MFIs. Bangladesh has enacted regulation of the sector only in 2006 when a Central Authority to regulate microcredit was set up.

The policy with regard to microfinance in India has been largely positive and developmental and at the same time marked by caution and prudence. While the policy has brought the sector to its current state of development, in order to enable the sector to grow further in an orderly manner, certain major policy initiatives need to be taken. The most important missing link in the country's financial inclusion efforts is that of adequate saving channels for the poor. While commercial banks, regional rural banks and post offices, have good geographical networks, they are often unable to provide the doorstep collection of small deposits on a regular, frequent basis as required by the low income groups. These groups are usually unable to visit formal financial institutions during specified working hours without incurring considerable transaction costs in terms of time and money. MFI operations on the other hand are tailored to more effectively meet their requirements and hence they should be permitted to provide savings services. While the BC model attempts to increase savings avenues for the poor, large MFIs which have the scale required to provide these services in an economic manner, have not been incentivised to participate in it.

The other important missing link in the country is the inability of the low income persons to access affordable remittance and payments services. Mobile banking provides the greatest scope for this to take place. It is proposed that to address these two missing links, some of the large MFIs should be selectively permitted to be converted to a special category of MFI banks with lower initial capital requirements. These MFI banks should be permitted to offer savings as well as mobile payment

services. Given the large geographic area of the country, licenses to collect deposits need to be provided selectively to entities, so as to enable effective regulation. Regulators should assess an MFI thoroughly based on financial, management and operational criteria. These entities should also have the capability to increase outreach substantially and reap economies of scale and scope so that lending costs in microfinance reduce considerably. Large MFIs who have a satisfactory track record are possible likely candidates.

After license is provided, continued supervision and monitoring of these entities is called for. It may be desirable to extend deposit insurance which is presently available to depositors in commercial and cooperative banks (up to an amount of Rs. 0.1 million) to MFI Bank depositors, though it may also create moral hazard issues. In any case, the contingent liability of the savings collected is likely to be on the State given India's political economy characteristics. This therefore calls for strict and close supervision and regulation. The MFI banks should also be permitted to offer mobile payment services. The benefits for customers include quicker and cheaper transfer of money and a means to save small amounts of money for emergencies. The huge customer base and powerful brand of the mobile company enabled outreach to unbanked segments of the population. As regulators in many countries do not permit non bank entities to offer banking services, other models have developed. In India, permitting MFI banks to partner with mobile companies to offer mobile banking services has the potential to enable access to remittance services to a large number of unbanked customers. While the banks have a relationship with these customers and are best placed to service them, the mobile companies have the technology and expertise required Such collaborations can bring down transaction costs considerably.

RBI would be an appropriate choice for prudential regulation of MFI banks, as it is the regulator for banks in India. This may stretch the regulatory capacity of RBI but would nevertheless be a worthwhile investment for the country as in the long run it could result in large scale financial inclusion and financial deepening. Training a team of officials at RBI on various microfinance models and the peculiarities of microfinance regulation as well as the intricacies of prudential regulation will be required. The non prudential regulation of MFIs may be carried out by an independent regulator in the nature of an oversight board reporting to the RBI, so as to not to overstretch the regulatory capacity of RBI. The board should be broad based in nature consisting of representatives from Government, banks, MFIs, SHG federations, Sa-dhan, NGOs and consumer forums.

MFIs of all legal forms should be required to register themselves with this regulator and adhere to the uniform code of conduct prescribed. The code should cover truth in lending, transparency with regard to charges, financial education, selling appropriate financial products, practices for monitoring and collection as well as norms for provisioning of loans. Channels for customer complaints and dispute resolution should also be provided. The regulator should use creative means for communicating with SHG and MFI members so that they are made aware of them. The regulator should coordinate with other financial sector regulators namely IRDA and PFRDA with regard to insurance and pension services.

The above recommendations effectively amount to having two regulators. For prudential supervision of MFI banks, regulation by RBI is proposed. For non prudential supervision for the sector as a whole, an independent oversight board (OB) reporting to the RBI is suggested. The members of the OB should have the requisite expertise as a group and access to public and private sector experts. This can be accomplished through appropriate advisory committees. The creation of regulatory capacity for prudential and non prudential regulation of the Indian microfinance sector will be a major challenge but is likely to be a worthwhile investment for the country as in the long run it could result in large scale financial inclusion and financial deepening.

In conclusion, it is time to address regulatory issues to enable the microfinance sector to contribute more effectively to the goal of financial inclusion, and to provide an environment in which all stakeholders can participate with confidence.

REFERENCES

- Aklilu, Y (2002), "The Importance of Micro Finance Institutions in Developing Economies: Country Experience and Policy Implications to Ethiopia", *NBE Staff Working Paper,* ERD/SWP/005/2002.
- Almario, J, E Jimenez and BR Pia (2006) : *The development and implementation of a uniform set of performance standards for all types of microfinance institutions in the* P/i///pp/nes (http://wwwmicrofinanceregulationcenterorg/files/34558_file_Philippines_PESOpdf).
- Basu P and Srivastava P (2005), 'Scaling-up microfinance for India's rural poor' *World Bank Policy Research Working Paper 3646, June, 2005.*
- Basu JC, Woller G (2004) "Microfinance a comprehensive review of existing literature", *Journal of Entrepreneurial Finance and Business Ventures 9(l):l-26.*
- Cull R, DemigAuc-Kunt A, Morduch J (2007), "Financial performance and outreach: A global analysis of leading micro banks", *Journal of Economics 117(517): 107-133.*
- Christen, P, E Rhyne, R C Vogel, and C McKean (1995), "Maximizing the Outreach of Micro enterprise Finance; An analysis of Successful Micro finance programs", *Program and Operations Assessment Report No. 10, USAID, Washington, D.C.*
- Crombrugghe, De Alain, Tenikue Michael & Surdea J (2007), "Performance Analysis for a Sample of Microfinance Institutions in India, *Annals of Public and Cooperative Economies", Vol. 79, Issue 2, pp 269-299, June, 2007.*
- Hishigsuren G (2004), "Scaling up and mission drift: Can Microfinance institutions maintain a poverty alleviation mission while scaling up?" *Unpublished PhD thesis, Southern New Hampshire University.*
- Hulme, D and P Mosley (1996), *Finance Against Poverty, Volumes 1 and 2, Routledge, London.*
- Jean-Luc C (2006), "Micro and Small Enterprises and Micro finance in Africa, the support to dynamic enterprises: an effective weapon for poverty alleviation" *Quarterly bulletin of National Bank of Ethiopia, Nov. 2005-Jun. 2006.*
- Maegher, P (2002) : Microfinance Regulation in Developing Countries: A Comparative Review of Current Practice *IRIS Centre* Viewed on 10 March 2009.
- Martzys RO (2006), "Microfinance Institutions: Profitability at the service of Outreach- A study of Microfinance Industry in the ECA region", *MA thesis.*
- Meyer, R L (2002), "Track Record of Financial Institutions in Assisting the Poor in Asia" *ADB Institute Research Paper, No 49, December 2002.*
- Navajas, S, M Schreiner, R L Meyer, C Gonzalez-Vega and J Rodriguez-Meza (2000), "Micro credit and the Poorest of the Poor: Theory and Evidence from Bolivia", *World Development, Vol. 28, No. 2, pp 333-346, Elsevier Science Ltd.*
- Nair A, (2005), 'Sustainability of microfinance self help groups in India: would federating help?' *World Bank Policy Research Working Paper 3516, February.*
- Porteous, D (2006) : *Competition and Microcredit Interest Rates,* (http://wwwcgaporg/).
- Rhyne, E and Otero, M(1994), "The New World of Micro enterprise Finance" *,Hartford Kumarian Press.*
- Sebstand and Chen, (1996), "Impact Study of Microfinance Institutions", *International Journal of Social Welfare, Vol 6, Issue 2, pp 123-139.*
- SA DHAN, (2005), *Side by Side: a Slice of Microfinance Operations in India,* New Delhi: Sa Dhan, September.
- Stiglitz JE and Weiss A, (1981), "Credit rationing in markets with imperfect information", *American Economic Review, 71, 3, 393-410.*
- Surdea J, (2005), "The financial performance of a microfinance institution: case study in India", *Masters Thesis in Management, FUNDP-Namur.*
- Von Pischke, J D (1991), "Finance at the Frontier"; *Economic Development Institute, World Bank, Washington, D.C.*