Microfinance Industry in India: More Thoughts

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Microfinance institutions need not be treated as holy cows. They do not need any soft regulation. They should be treated on par with any non-banking companies. A comment on Y V Reddy's article on microfinance and a response from the author.

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In the article "Microfinance Industry in India: Some Thoughts" (EPW, 8 October 2011), Y V Reddy has expressed some thoughts about the microfinance industry (MFI) and the current crisis. Reddy's thoughts on this matter are critical and cannot be easily ignored not only because of what he is saying, but also because of who he was – the governor of the Reserve Bank of India (RBI).

Through a Regulatory Lens

In his article, Reddy talks about the state of the microfinance industry from a regulatory lens and bases his arguments on the incidents that happened in 2006 in Andhra Pradesh. While Reddy argues that the RBI adopted a soft-regulatory approach, almost amounting to being hands-off and claims that "…significant interest was expressed by RBI in regard to extending microfinance activity, essentially as extended arms of the individual branches of the banks and not as parallel financial intermediaries…" (p 46). We find this argument untenable. In fact, the approach of the RBI was that of encouragement and promotion of these parallel financial intermediaries.

A review of the regulatory history shows the remarkable consistency in the hands-off approach on regulation, with an active tone of encouragement adopted by the RBI, starting with the recommendations of the Task Force on Supportive Policy and Regulatory Framework for Microfinance in 1999.

While we do not intend to delve on the significant regulatory commitments of the RBI that encouraged MFIS of all types (for-profit as well as the not-for-profit), attention should be drawn to a communication addressed by the RBI to all scheduled commercial banks in February 2000 with the title "Microcredit",[1] in fact, defined microcredit as

> Microcredit is defined as the provision of thrift, credit and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards. Microcredit institutions are those which provide these facilities.

In fact, the notification actually makes the following six significant points vis-à-vis microfinance: (1) no interest rate cap on loans to MFIS and their loans to clients, (2) freedom to banks to formulate their own model/conduit/intermediary for extending microcredit, (3) no criteria prescribed for selecting MFIS, (4) banks to formulate their own lending norms, (5) banks to formulate a simple system, minimum procedures and documentation for augmenting the flow of credit by removing all operational irritants, and (6) the banks were to include microcredit at the branch, block, district and state credit plans with quarterly progress to be reported to RBI.

Microfinance also crept into the annual *Trend and Progress of Banking in India* report, without a formal definition of what microfinance is (except for the definition in the notification above). The approach of the RBI since 1999 has been (and rightly so) to promote plurality of institutions.

For Profit/Non-Profit Debate

The essence of Reddy's argument in his lecture is that the RBI took a soft regulatory approach with the MFIS because they were initially not-for-profit institutions; they were working with the poor; and there was an underlying assumption about the commitment of these institutions to their stated values.

Arguing about the for-profit/non-profit debate, he even brings in the principled stand of RBI, divesting its share from the Infrastructure Development Finance Corporation the moment it decided to go in for a public issue. There is a difference between being an active shareholder in a government promoted institution and divesting its stake on a matter of principle and taking a "principled stand" with respect to regulating for-profit MFIs. The RBI was not a shareholder in any MFI. It has not taken a principled stand that for-profit institutions should not be in banking. Indeed, all the institutions in banking are for-profit and most of them are listed. So, how these principles of not participating in equity apply to regulating non-banking financial companies (NBFCs)-MFIs, which are for profit is not clear.

Arguments and Diagnosis

While there are some internally contradictory arguments in Reddy's paper, we should try and look at the role of RBI from a perspective of a regulatory failure afresh, so that the debate on MFIs and the crisis of microfinance can be carried forward. Reddy's article provides a good platform to open up the debate. We shall place our arguments and diagnosis from a regulatory point of view below:

(1) The MFIs, after trying to find their feet in the initial years started growing at an unbelievable pace. Most MFIs grew at a rate higher than 100% for several years. Such a fast pace of growth in the financial sector in itself should have raised red-flags in the regulatory set-up like RBI. Any sector growing at such a pace consistently is obviously attracting enough capital and funding, and if such funding is unlimited, there is a return that is beyond normal. If we dissect this we find that such growth was initially fuelled by innovative loan products offered by the ICICI Bank and the Small Industries Development Bank of India (SIDBI) that made the capital adequacy of the MFIs irrelevant. The ICICI Bank offered on-tap securitisation and partnership product, which lent the strength of the ICICI balance sheet to small MFIs that had soft-touch regulation. Clearly, there was a regulatory arbitrage. SIDBI apart from funding MFIs very aggressively also offered liquidity support in the form of an innovative "transformation loan" at subsidised interest rates for the not-for-profit MFIs to "convert" to for-profit entities, which opened up the flood gates for equity investments. Both these institutions were very much under the supervisory oversight of RBI.

(2) Following this there were huge inflows of capital into MFIs from private equity firms, including significant amount foreign funds. The valuations at which these entities bought into MFIs should have waved a red flag to the regulator. The valuations were astronomical not only by standards of banks and NBFCs, but also when compared with the valuations got by similar MFIs in other countries. Clearly, if such capital was flowing in, it would continue to expect consistently high returns. RBI being a regulator of the financial sector, was best place to look at the nature of capital flows and its impact on "usurious interest rates".

Behavioural Problems

If the RBI had looked at these two signals, then it would have reacted differently. The current crisis in microfinance is attributed to three significant behavioural problems of the MFIs. These problems are: (1) the allegation that the MFIs are charging usurious interest rates, (2) the clients have borrowed from multiple MFIs and gone into a debt-trap like situation, and (3) the MFIs are resorting to coercive recovery practices.

All the three elements can be traced back to the nature of capital that has flown into the MFI sector. Reddy is right when he says that the assumption that for-profit MFIs are committed to a particular activity, viz, microcredit for the poor, has also become suspect going by the plans of some of these institutions to enter the gold loans business. Clearly, the investors were demanding their pound of flesh from the MFIs and the MFIs were desperately looking for some opportunities to survive, when their basic bread and butter business has become untenable.

Institutional Plurality

If we were to accept the above argument, we would then realise that the solution possibly did not lie in increasing capital adequacy, changing prudential norms or even imposing interest rate caps. At the source, the RBI did not pay enough attention to the "quality" of capital that was flowing in – whether such capital was patient enough to do business with the poor. At the customer level, the RBI failed to protect the customers adequately from predatory lending practices. While Reddy says that putting faith in the commitments of the MFIs through a code of conduct was inappropriate, he also admits that "RBI should have insisted on enforceable regulation and not been content with an advisory role" (p 47). Taking this point further, Ramesh Ramanathan[2] in a recent article argued:

> Unbridled laissez-faire is perilous when it comes to the poor. Relying solely on market equilibrated prices and behaviour is misplaced for three reasons: structurally inappropriate due to massive information asymmetries in the marketplace; morally unacceptable, given the vulnerability of the poor; and politically unfeasible given the entrenched patron-client relationship between politicians and the poor.

Clearly the response of the RBI to the issues arising out of the crisis of 2006 was inadequate. However, to suddenly turnaround and term microfinance as leveraged moneylending might be misplaced. We argue that MFIS are certainly a better option than moneylenders for one significant reason. MFIS are legal entities, are visible, fall within the regulatory radar, can be called to table and reasoned, can be penalised, and can be made to behave.

Therefore, while it is important to understand the role of MFIS and their limitations which Reddy has adequately pointed out in his article, we also need to argue for institutional plurality when it comes to the agenda of inclusion. Yes, the MFIS need not be treated as holy cows. They do not need any soft regulation. They should be treated on par with any NBFC. They should not be allowed to take a back door entry into banking functions. However, as a formal company registered with the RBI, they not only deserve to exist and negotiate their survival, they also deserve the regulatory attention of the body that has permitted them to operate.

The proposed microfinance bill is a different matter and as Reddy points out, it has serious flaws in the "soft" clauses that allow them to do bank like activities. There has to be a regulatory level-playing field. The best example of providing such a framework is available in the recent report on NBFC regulations submitted by a committee headed by Usha Thorat.[3] Unfortunately that report has kept MFIS out of its recommendatory purview. That indeed is a tragedy because the RBI seems to continue to keep MFIS out of the mainstream regulatory discourse and deals with these institutions somewhat guardedly and carefully, and sometimes with an unnecessary vehemence as indicated by the post-Malegam notifications.

Conclusions

In conclusion, while the RBI could use the state governments as instrumentality to carry out its inability to deal with the last mile issues – as it does with a series of memoranda of understanding executed in the context of urban cooperative banks, it cannot abdicate its responsibility of regulation. The debate between monetary management and regulation raised by Reddy is a separate debate. However, this debate is about regulatory convergence. Since the RBI is the regulator for banks as well as NBFCS, it cannot treat MFIS that are NBFCS as a problem of the state governments. These are formal institutions, inviting capital flows and trying to list themselves. Therefore, it is important for RBI to play its role rightfully and effectively.

NOTES

1 RBI (2000), Communication No: RPCD.NO.PL. BC. 62 /04.09.01/99-2000, dated 18 February. Accessed from the RBI website on 6 February 2011. http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=127&Mode=0

2 Ramesh Ramanathan, "A Place under the Sun for Microfinance", *Mint*, 4 November 2011.

3 Working Group on the Issues and Concerns in the NBFC Sector: Report and Recommendations submitted to the RBI.

A Response

Y V REDDY

MS Sriram in his comments on my article has articulated views on the subject mainly from the point of view of the microfinance industry, and this is therefore a very useful supplement to the comments made by me, which were mainly from the regulatory point of view, based on my limited personal experience. I am sure this debate will lead to consideration of a broader set of issues, keeping the totality of the management of the macroeconomy, monetary policy, and financial sector for promotion of growth with equity. The debate should ideally encompass the role of the monetary authority, the difference between banks (which operate the payment system as well as accept retail deposits) and non-banks, the deposit taking institutions, etc. The optimal level and composition of the activities that could be undertaken by an institution like the RBI is also relevant. The regulation of cooperative credit institutions which are also active in rural areas should form part of the broader analysis. Incidental, if not integral to this debate, should be the role of moneylenders and that of the Moneylenders' Act in the past, present and in future, given the reality and magnitudes of their presence, and the fact that they are not leveraged.

By way of clarification, I would like to mention that my account of RBI's policy was mainly in terms of my personal involvement, and hence more focused on the post-2003 developments. During this period, financial inclusion became a more formal agenda in the policy of the RBI. The illustration of IDFC was essentially relating to the RBI's involvement and our approach to the incentive framework of an institution that is funded by equity capital and is seeking to maximise returns, while simultaneously seeking special treatment for a particular type of promotional work that it was claiming to be doing.

It will be useful to assess whether the analysis made by Sriram implies a distinction between for-profit and not-for-profit MFIS, from the point of view of the regulators, consumers, and state governments. It will also be useful to verify whether moneylenders are required to be registered (though many may not) under the relevant Acts.