MICROFINANCE REBORN

An agenda for reinvention and reincarnation

MFIs are battling a crisis of confidence after the Andhra Pradesh government in October passed an ordinance to rein them in amid concerns that they were charging exorbitant interest rates and adopting coercive loan recovery methods. What can be done to catalyse the industry's transformation?

By Narayan Ramachandran & M.S. Sriram

Microfinance in India, as we know it, is dead. However, unlike mere mortals, organizations, ideas and concepts never really die. Like Hindu philosophy, which talks about the mortality of the body and immortality of the soul, we need to understand that the idea of microfinance will survive this crisis. As long as poverty is not banished to museums and the dream of Grameen Bank founder Muhammad Yunus is not realized, there is always scope for us to reinvent and redraw the architecture in which the soul could find a new abode.

The non-negotiables

The non-negotiables of the idea of microfinance or financial inclusion are clear: We need to provide a dignified access to a suite of financial services to the last man and the last woman of the nation. This access can be provided by various actors in various institutional forms. The plurality in the system is to be encouraged at all costs because it produces debate, provides diversity; improves choice and, most importantly, reduces prices for the consumer.

This suggests the second non-negotiable, which is external interference in price (or, in this case, interest rates that are charged). This not only sets a bad precedent for all sectors of the economy, it pre-supposes that there is a way to arrive at the right price that is not market-determined. Much better then to encourage competition and focus on fairness than to administer prices.

We need ideological counterpoints and intellectual stimulus to be alive and to constantly reinvent. Therefore, we need to reflect on the current crisis in the microfinance sector and use these learnings to move on. Enough has been written on the diagnosis of the problem and what went wrong. Here is our take on how it could be set right.

Policy framework

Financial services to the poor are delivered by a range of providers: the informal moneylenders, self-help groups (SHGs), the cooperatives, microfinance institutions (MFIs), regional rural banks (RRBs) and commercial banks, touch points of international banks and so on.

There have been changes in each of these spaces, and most of these changes have been in a positive direction of removing hurdles and providing for a framework for the population in general and the poor in particular to access these sources. These changes inter alia are:

- Classifying SHG loans as secured loans for purpose of prudential norms and asset classification, thereby encouraging banks to participate in this segment
- Classifying microfinance loans under the priority sector, thereby providing an attractive option to on-lend for microfinance
- Allowing the consolidation of RRBs so that they achieve economies of scale as well as get sufficient top management attention

Hemant Mishra/Mint

Reworking model: *A loan officer at a meeting with borrowers at a village near Mysore.*

- Encouraging commercial banks to reach out to the last person by mandating them to prepare a three-year financial inclusion plan, easing of know your customer, or KYC, norms for no-frills accounts, removing prior licensing requirements to open branches in locations that have a population of less than 50,000 and mandating the banks to reach all villages having a population of more than 2,000
- Opening up policy to hire business correspondents to reach out to people without a brick and mortar set-up
- Revamping and recapitalizing the cooperative network so that cooperatives are able to achieve capital adequacy and also continue working with the poor as vibrant institutions working on the principle of mutuality
- Passing of the MACS (mutually-aided cooperative societies) Act by several state governments, paving the way for newer and vibrant people's collectives to emerge

In all the above policy initiatives, the one form of organization that has been totally ignored are the MFIs. The microfinance sector has been asking for legislation and when the legislation did come into the public discourse, it was not only badly drafted, it left out the largest segment of the players in the market—the for-profit NBFCs (non-banking financial companies) that were undertaking microfinance activities.

Future framework

Going forward, we would like to see the following changes in the regulatory framework that would help MFIs to continue working with their clients, augmenting the efforts of the government and the public sector in making financial services available to the poor.

Definition: Microfinance is not defined anywhere in our legislative framework. The only attempt to define microfinance was in the proposed Act and in an obscure notification of by the Reserve Bank of India exempting not-for-profit organizations giving loans of less than ₹50,000 from the registration requirements under the NBFC regulations.

We suggest that RBI create a new category of NBFCs—the MFI NBFCs (like the six other classifications that are already existing, including chit funds and housing finance companies). This category could be defined in RBI's own language—as organizations offering purely "small borrowal accounts"—currently defined as loan accounts having a sanction limit of ₹2 lakh. RBI could fix a percentage of the portfolio to be small borrowal accounts in order to enable classification—say 90%.

Given that MFIs might want to give micro-housing loans as well, and the ticket size might go beyond this amount, we suggest that 90% of the accounts could be a good number to start with. The caveat here is that there might be multiple borrowings by the same borrower.

Therefore, as a refinement, the stipulation (not only here but also in case of the reporting of banks) should be number of unique customers having sanction limits of less than the amount rather than the number of accounts.

Asset/liability: Allow MFIs to collect client deposits. Clearly, RBI sees a systemic risk in this audacious recommendation. However, given that on the asset side, there could be no bulk loans to companies, RBI's worry is that it may be used for diversion of funds. There could be clear regulation on where surplus liquidity could be deployed, ruling out corporate deposits, preferential shares, and direct equity investments, but specifying only an approved list of securities as indicated by the charities commissioner for trusts and societies.

Reciprocity: Ensure that the MFI is not liable to the client more than the client is liable to the MFI at any time. By definition, the deposits of the clients are always less than their outstanding loans, while they do get a safe place and a nearby touch point for accessing savings services. We could go a step further to say that if there are situations where the client savings exceed the loan amount, the excess amount (identifiable to each customer) should be parked in an escrow type of account with a scheduled bank, ensuring liquidity at all times. Thereby, we are indicating that to start with, savings can merely be a service offered by the MFI to its clients.

Governance: There are two issues. One is philosophical—not all the poor want loans, some may only want to save. Two, how to operationalize. Very tough. Can have a ceiling on savings amount—risks multiple accounts, etc., but at least offers a deterrent

Revamp the governance structure to mandatorily include one or two board positions for persons representing the client interests and client protection. Ease the induction of persons from public financial institutions on to the boards of the MFIs. Ensure that the independent directors are truly independent with no conflict of interest in the company, meaning that they would not have shares or/and will not get options and their compensation is not aligned with the financial or stock market performance of the company.

Executive compensation: Ensure that the compensation structure of the senior management is not out of sync with what is specified in the Companies Act, and no special permissions should be given for going beyond the limits specified in the Act on the incentive structure. Like it already does for CEOs of banks, RBI should approve all elements of CEO compensation.

Credit registry: The microfinance industry faces criticism for overlending. The industry, in consultation with RBI, must hasten the mandatory requirement for a unique identity for each customer and establish a clear and urgent timeline to log all transactions in this registry.

This registry can be a mutually-owned utility for the industry which uses a large-scale records processor like the **National Security Depository Ltd** (NSDL) for its back-end technology. Full and timely information should be available to RBI.

Insurance: While MFIs have pretty good credit records overall, they run the risk of episodic, often externally imposed, credit failure (such as the latest one). Funded by the industry, a mutual insurance entity should be established to see them through these difficulties. The mechanism of funding would be a percentage of "excess profits" beyond a certain return on assets (ROA) or return on equity (ROE) number.

Financial transparency: To ensure that diversion of funds is eliminated, mandatorily require all MFIs to undergo an annual portfolio audit through an independent agency, which is different from the agency that is conducting the statutory audit and the internal audit. This will ensure that the allegation of diversion of funds is taken care of.

Establish clear ROE and/or ROA limits beyond which economies of scale benefits are passed back to the consumer.

Universalization: While MFIs do a pretty good job of extending credit to many segments, they do a pretty poor job of extending it to the most destitute segment of society. Again a percentage of "excess profits" as above should fund livelihood projects in that segment.

Have a clear multiplier to ensure that they are not overleveraged. The overall leveraging ceiling should include not only the portfolio, but also the assets under management.

Catalysing rebirth

We believe that bringing in such radical changes will catalyse the rebirth of microfinance activity in India. Several of the above norms can be eased to morph MFIs into small finance banks as they mature and show responsible behaviour (consistent with the Raghuram Rajan committee report).

We believe that the above measures will improve the accountability of MFIs towards their clients. Clients will have a stake in MFIs in the form of savings. RBI could issue appropriate clarifications on the interest band for savings to ensure that the clients are given a fair deal.

We believe that there should be a conducive and enabling environment for any well-meaning entrepreneur to do business even with the poor, and any deviation from acceptable behaviour should be dealt with a heavy hand. Transparent, consistent regulation, combined with an enabling environment for enterprise and objective enforcement of rules is the recipe for a vibrant sector that meets a clear need.

Unfortunately, RBI and policymakers tend to shut out the options even for legitimate businesses because of a crisis. We need to understand that every legislation will throw up some organizations operating on the frontiers/margins. We need to encourage organizations on the frontiers and identify their merits and come down heavily on the organizations operating on the margins pretending to be what they are not.

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