REGULATORY ENVIRONMENT FOR MICRO-FINANCE INSTITUTIONS IN INDIA

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Abstract

A major goal of micro finance in India is poverty alleviation though inclusive financial growth of all poor citizens. A majority of Indian population is below the poverty line and they have no access to formal financial services. Hence, the Micro Finance Institutions (MFIs) are established with a mission to provide financial services to the poor population through micro lending in the form of smaller loans so that they are used as seeds of income generating activities or further developing their existing businesses; it also includes savings of part of their incomes and insurance. With themicro loans, it is expected that the poor beneficiaries would gradually develop their businesses and increase their income. This would in turn improve their ability of loan repayment so that it is accomplished in a planned manner. Aninitial success would instil confidence in the poor borrowers and it would attract higher loans for further development of their businesses. Although the micro financing is viewed as a not-for-profit and socio-economic development of poor with societal goals, later as the MFIs are grown in number and fiscal circulation increased many folds, slowly, the not-for-profit motto has been transformed in to for-profit motto. In this process, the MFIs started investing hundreds of crores of Rupees, gaining more profits and their businesses grew several folds, consequent upon the increased and irrational loan lending to the poor, who could never repay their loans. Hence, some MFIs resorted to coercive methods by which the borrowers were forced to repay their loans, and this led to failure of whole system at least in some parts of the country and many borrowers committed suicides. The prevalence of highly stressed poor borrowers and loss of life and properties, Government and Banking Regulatory bodies came into saving the poor borrowers. This mandated strengthening of existing rules and regulations or enactment of new laws for enforcing the MFIs in a way the processes of lending and recovery of loans are judicially formulated and the poor borrowers are saved from the tortuous commercial MFIs. A major problem in bringing all MFIs under one legal framework is the existence of multiple regulators both at national and state levels. Regulations of MFIs through Acts have been legislated both at Central Parliament and State

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Assemblies and no clarity emerged as to how they would work together as the MFIs faced dual or even multiple regulatory systems. In addition to this commotion, there are different types of MFIs, and each one of them are established and governed by different regulators, Acts, Rules and Regulations. Hence, there is a gross confusion as to how to control all MFIs under one legal regime and the conflicts have gone to the judicial review systems and unique judgements did not emerge. The present legal framework and regulations are grossly inadequate and are mutually conflicting each other. Hence, the need of the hour is development of a single regulator and a unique legal framework that applies to all MFIs, although they are established by different registration pathways.

Introduction

Micro Finance Institutions (MFIs) in India took about four decades to reach the present structure. In the progress of four decades, different types of MFIs developed. Some are not-for-profit, a few are mutual-benefit and many others are for-profit institutions. Obviously, for-profit institutions outnumbered (~90%) the not-for-profit organizations, for the obvious reasons of sustainability through profit making mechanisms. All three categories of MFIs are governed by distinct regulatory bodies and rules and regulations. While for-profit entities attracted equity investments, the not-for-profit institutions attracted only a smaller amount of capitals. Since there was no single regulator and regulatory mechanisms, each institution followed its own functional regulations and level of transfer of benefits to poor borrowers highly varied between them. While the not-for-profit facilitate smaller amounts of lending, the for-profit MFIs offered large and multiple loans. Likewise, the not-for-profit MFIs levied smaller rate of interests, the for-profit MFIs levied higher rate of interest and in-human and coercive ways of recovering loans from the poor borrowers. The poor borrowers rushed to for-profit MFIs with a narrow objective of gaining more loans and easier mode of loan approval and dispersal. This caused tremendous growth of for-profit MFIs in the last three decades, while the not-for-profit MFIs faced slower growth and became less attractive to poor borrowers. The loan delivery mechanism has also undergone significant changes. Although the individuals are the beneficiaries, the formation of Self Help Groups (SHGs) is one of the greatest innovations that ushered upliftment of poor and poverty alleviations. In this model, a few women members are grouped as a SHG, and the loan is awarded as a group lending. Hence, the SHG as a whole takes the responsibility of distribution of loan amount among themselves and loan repayment is done as a team. Women were encouraged to form SHGs rather than men, as women showed greater responsibility and utilization of funds towards projected deliverables. Later, the SHGs are linked to Banks through SHG-Bank linkage program so that the groups get formal financial services from the main stream banking sectors. The SHGs are also linked to Banks indirectly through a facilitating agency. SHGs are also linked to Non-Governmental Organization MFIs. Hence, the rules and regulations pertaining to micro finance sectors should take into account both borrowers and service providers. Before going into the existing regulations that govern the MFIs in India, let us first review what the different types of MFIs are present in India currently and how they are created following distinct registration processes.

Types of MFIs and their Charted Functions

MFIs are of three categories: not-for-profit, mutual benefit and for-profit entities. There are three types of not-for-profit MFIs: Non-Governmental Organization MFIs (NGO-MFIs), Trusts, and Section 25 Companies. The NGO-MFIs are created by the registration under Societies Registration Act, 1860, Trusts are under Indian Trust Act 1882, and Section 25 Companies are under Section 25 of Companies Act. The not-for-profit MFIs are exempt from the income tax. However, their financial tractions are accounted and annually audited by competent authorities. The Cooperative Societies that offer micro financing are considered to be mutual benefit type MFIs and are registered under State Cooperative Societies Act or Mutually Aided Cooperative Societies Act or Multi-State Cooperative Societies Act. The Cooperative MFIs address the need of their members only. Non-Banking Finance Companies (NBFC) and NBFC-MFIs are for-profit MFI types, and they are registered under the Companies Act 1956 and RBI Circular dated May 2011, respectively. Hence, it is clear that MFIs of different types are governed by different Acts and hence they are subjected to distinct regulatory framework. Also the income accrued by the NBFCs or NBFC-MIFs are taxable. Regional Rural Banks (RRBs) and Local Area Banks (LABs) also offer micro finance services. The establishment of RRBs is notified through Central Government Gazette, while the LABs are created through Indian Companies Act, 1956. These banks can mobilize the funds from public.

Both not-for-profit and mutual-benefit MFIs are generally included in the Microfiance Institutions (Development and Regulation) Bill, 2011, while the major regulations pertaining to for-profit MFIs are stipulated by the Reserve Bank of India (RBI). Apart from these are separate state level Acts are also applicable to the MFIs, for example, Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act, 2011, are also applicable to those MFIs fall under the jurisdiction of state boundaries.

For-profit MFIs constitute about 80% of the total micro financing sectors. Hence, greater attention is needed to regulate the for-profit entities. Thus, RBI has stipulated a stringent regulatory framework for NBFC-MIFs as they come under the purview of profit making portfolios and are allowed to accept public deposits hence requiring a mechanism that inhibits the higher risk of equity investments. Both prudential and non-prudential regulations are also applicable to NBFCs. The basic difference between NBFC and NBFC-MFI is the former has the accessibility to the capital markets, while the latter is purely involved in the priority sector funding. The RBI regulations pertaining to NBFC-MFIs require that at least 75% of their loan portfolios must be originated for income generating activities. In addition, according RBI regulations, the NBFC-MFIs must have 85% of total assets as qualifying assets. A qualifying asset is a loan which meets the following criteria: (a) A borrower's income does not exceed Rs. 60,000 or 1,20,000 respectively for rural and urban areas, (b) A first loan amount does not exceed Rs. 35,000 and subsequent loan not more than Rs. 50,000, (c) loan tenure does not exceed 24 months, (d) no penalties for late payment, (e) no collateral allowed, and (f) weekly or monthly repayment structure. Another aspect is priority sector lending and according to this, banks have to allocate a portion of their portfolios to specified priority sectors at concessional rates of interest. The priority sectors include: (i) Agriculture, (ii) Micro, Small and Medium Enterprises, (iii) Export Credit, (iv) Education, (v) Housing, (vi) Social Infrastructure, (vii) Renewable Energy, and (viii) Others.

It is mandatory that the NBFC-MFI adheres to fair and transparent practices when it deals with the borrower under the guidelines of Fair Practices Code stipulated by RBI. Also, there is no need for security deposit/ margin/collateral. Also the borrowers must be ensured of unchanging rate of interest, know your customer information, acknowledgements and receipts for all instalment paid, charging of interest rate on a reducing balance basis, and no levy of penalty on delayed payments. These regulations grossly take care of the interest of the borrowers.

Deposits and Access to Capital

As per the Acts under which the MFIs are registered, only for-profit organizations (NBFC and NBFC-MFI) are allowed to accept the public deposits, provided they adhere to additional stringent regulations. NBFCs are also allowed to raise the equity investments from foreign sources, provided they are restricted to half-a-million US dollars. On the other hand, the not-for-profit MFIs are not entitled to receipt of public deposits, but they can obtain funds from the open markets including from the banking sectors. Cooperative MFIs can acquire deposits from their members. MFIs in principle can raise their capital funds from various resources subject to the Acts under which they are registered.

Aspects of Micro Finance Institutions (Development and Regulation) Bill 2012

Micro Finance Institutions (Development and Regulation) Bill, 2012, shortly MFIDRB, 2012, defines its purpose is "*to provide for development and regulation of the micro finance institutions for the purpose of facilitating access to credit, thrift and other micro finance services to the rural and urban poor and certain disadvantaged sections of the people and promoting financial inclusion through such institutions and for matters connected therewith or incidental thereto."* It is clear from its objective that the bill addresses the financial inclusion of the poor through regulated services of MFIs. The Act envisages that Micro Finance Development Council is developed by the Central Government with core members from different expertise. The Council shall advise the Central Government on formulation of policies and measures to be undertaken for orderly growth and development of micro finance institutions and schemes to be framed therefor. The Bill also enacts the establishment of a State Micro Finance Council for micro finance services in each State and considering the extent of micro finance activities in the States, establish such a Micro Finance Council for two or more States. The State Council is to coordinate the activities of the District Micro Finance Committees in the State, review growth and development of micro finance activities in the State, monitor over-indebtedness caused by micro finance institutions in the State, and monitor whether methods of recovery used by micro finance institutions are in accordance with the guidelines made by the Reserve Bank and to report to the Reserve Bank in respect of the violations, if any. Hence, the State Councils have greater role in monitoring of MFIs at State level. A District Micro Finance Committee in each district is constituted by RBI and headed by the by the Collector or an officer not below the rank of Additional Collector in that district. The functionalities of the District Council are similar to those of the State Council but its jurisdiction restricted to the District level only. The District Council is mandated to submit a quarterly report to the RBI which in turns forwards the same to the State Council.

As per the proposed Act under this bill, every MFIs shall register their entity with the RBI and a certificate would be issued by RBI. The bill specifies the reserves, accounts, audits and returns. Under this Act, the RBI remains a sole regulator of all MFIs. The profit margin would be fixed by RBI and is regularly monitored by it. The Act also envisages the development of Micro Finance Development Fund, under the aegis of RBI and such funds are used to provide loans, refinance, grant, and seed capital to any MFIs or as investment of equity in MFIs. In addition, the fund utilization would also be monitored, apart from other activities. The said Bill having been referred to the select committee is under cold stage.

State Money Lending Acts

In view of the fact that there have been a n number of deaths owing to cruel poverty, ignited by usurious rate of interest for loan being collected by the rural lenders and those extending micro finance facilities, the composite state of Andhra Pradesh came up with a legislation, the Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act, 2011. It enforced all MFIs operating in the erstwhile united Andhra Pradesh to have registered under this Act, and without which the MFIs are restrained from collecting old loans or creating new loans. This Act encompasses "any person, partnership firm, group of persons, including a Company registered under the provisions of the Companies Act 1956, a Non-Banking Finance Company as defined under the Reserve Bank of India Act, 1934, a Society registered under the Andhra Pradesh Co-operative Societies Act, 1964, or the Andhra Pradesh Societies Registration Act, 2001 and the like, in whichever manner formed and by whatever name called, whose principal or incidental activity is to lend money or offer financial support of whatsoever nature to the below poverty line population". This Act also places restrictions on number of loans to SHGs by MFIs through under Section 10(4) of the Act. Further, MFIs shall display the rate of interest under Section 8 of the Act. They are prohibited from demanding any security by way of pawn, pledge or other securities for the loans, under Section 7 of the Act. A significant aspect of this Act is that the "Rule of Damdupat" is recognized under Section 9 of the Act, whereby the MFIs cannot recover any interest more than that of the Principal. Further, the sub-section 2 of Section 9 maintains that wherever MFIs realized equal to twice of the amount of Principal, the loan stood discharged and the amount recovered over and above the Principal is liable to be refunded. The principle of "Rule of Damdupat" is a principle of ancient Hindu Law applied only to certain provinces operating Hindu Law, is now made a secular principle applicable to all the SHGs and MFIs, irrespective of their religions.

When the vires of this legislation was questioned by SKS and other MFIs before the AP High Court, the division bench comprises of Chief Justice Pinaki Chandra Ghose and Justice Vilas V. Afzalpurkar dismissed the writ petition, upholding the Act.

Conflicting Arising from Too Many Regulations

As discussed before, different types of MFIs exist and each one of them are governed by a set of rules and regulations that are in force when the MFIs are registered as an entity as applicable to those Acts. For example, a set of norms under Section 25 of Companies Act would govern the MFIs created under that section. A major challenge is all MFIs created under different legal regimes contribute to micro financing under singular objective of poverty alleviation but operating with widely varying regulations. Can all MFIs have singular legal regime of fixation of rate of interest for this micro lending? Can there be a common rule for fixation of loan period and number of instalments? Can there be a singular rule pertaining to violations pertaining repayment of loans? Partly this was addressed in the Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act 2011. Similarly, Micro Finance Institutions (Development and Regulation) Bill2012 also proposed to bring all MFIs under singular regulation regime at country level. However, the latter has not yet been enacted and the former applies to only the AP State and many other states have not adapted a uniform legal framework for MFIs. Hence, operational conflicts exist between different types of MFIs created under different regulations, and between the State and Central regulators.

NBFCs raise major objections to dual or multiple regulations applied to a single MFI entity, because they are involved in micro financing with an aim to generate profits. While a particular regulation mandates lower levels of rate of interest, the regime allows flexible and profitable fixation of rate of interests. Obviously, NBFCs prefer to levy higher rates of interest following other type of regulations (e.g., Fair Practices Code). However, Kerala High Court ruled that the RBI's regulations and State Money Lenders Acts can work together without conflicts as they influence different spheres of MFI's functionality. On the other hand, in a judgment by Gujarat High Court opined that they should be balancing act between the different regulation regimes. The Supreme Court of India would be able to resolve this long pending issue of co-exiting multiple rules and regulations. It is concluded that the MFIs are required to be operated under a singular legal regime and enforcement of regulations so that uniformity is maintained and poor citizens undergo uniform treatment from different MFIs when they need services from them.

Conclusions

Since the Central Bill is in the cold storage and wherever State legislations are made, they are coming to the rescue of SHGs to a minimal extent. A review of entire literature has not brought out the market share of lending to SHGs by those other than MFIs, Public, Private Sector Banks, and Co-operative Banks. Despite of the regulatory mechanisms of RBI and NABARD, the life style of the people belonging to the lower strata is not changed significantly. Even the loans extended by the Public and Private Sector Banks and Co-operative Banks are not in commensurate with the demand of SHGs, and as a result, the wide gap is being filled by the native money lenders and other groups by subjecting these groups to make their sweat and blood, liquidated to meet their commitment to pay the extra interest. As a result, the Law should address all the issues concerning the lending to SHGs by all the stake holders, irrespective of their nomenclature, in the best interest of SHGs to make the Law more effective, else this legislation also would be a paper lion, making all the hopes and aspirations of the marginalized people frustrated.

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