

REGULATING THE GROWING COMMERCIALISATION OF MICROFINANCE INSTITUTIONS IN INDIA

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Microfinance Institutions ('MFIs') have always been considered as one of the frontline institutions for the propagation of financial services to the poor. Over the years, however, Indian MFIs have not seen the kind of success as their counterparts in Latin America, Europe and Bangladesh. Blind adoption of international models and subsequent commercialization by offering IPOs has not seen desired results. The critics say that MFIs, rather than becoming an alternate have replaced usurious moneylenders. Issues that have shown serious damage in the institutional structure are exorbitant interest rates, loan-sharking and excessive board room battles. Furthermore, legally it is very difficult to regulate the sector because there is a multitude of ways to incorporate such an institution. With each possible way of incorporation comes a new set of rules for its regulation. The question to be answered herein is commercialization of the MFIs the way forward for the sector. In this context, we look at the extant legal regime that governs the sector and the limitations that exist in it for regulating the commercial sector. We propose that such measures should be deterred in India at the moment. Due to the controversies that have plagued the market, especially in Andhra Pradesh, there have been a lot of calls for an independent regulator in the market. It is at this juncture that the New Microfinance regime has been introduced with the new Microfinance Bill and the Reserve Bank introducing a completely new notification setup. We, however, propose that a two-way model for a regulator is the way forward.

I. INTRODUCTION

Microfinance has become one of the primary means by which much required financial services are provided to small traders and craftsmen working in the informal sector of developing economies.¹ MFIs provide 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

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¹ Reinhard Schmidt, *Banking Regulation contra Microfinance*, 24 SAVINGS AND DEVELOPMENT 111 (2000).

levels and improve their living standards.² Financial services are considered as an inclusive term which extends to savings, insurance, and fund transfers as well.³ Microfinance has been high on the public agenda after the UN Year of Microcredit in 2005 and since the Nobel Peace Prize went to Mohammed Yunus and Grameen Bank in 2006.⁴ What should actually be attributed as the primary reason behind the success of the model of Grameen Bank is its existence as primarily a non-profit organization.

In India, the Reserve Bank of India ('RBI') has identified the growth of the microfinance sector as an important avenue through which the broader national goal of making a wide range of financial services accessible to increasing proportion of the population (usually referred to as financial inclusion goal) can be reached.⁵ In addition, the RBI considers lending by banks to the microfinance sector as a part of their priority sector lending requirements.⁶ Both these aspects increase the importance of ensuring orderly development and sound governance and regulatory structures for the microfinance sector.⁷

The regulation of MFIs in India has, however, been a controversial subject. In 2010, SKS Microfinance Limited, the largest provider of microfinance services in India,⁸ was in the spotlight because of its alleged violent recovery practices and a number of farmer suicides linked to inability to pay back its high-interest loans. Finally, in 2011, the Ministry of Finance proposed a comprehensive new Bill for the regulation of MFIs. Amongst these changes, lie fundamental questions relating to the regulation of this sector. Should MFIs be allowed to commercialise unfettered by issuing IPOs or should it be regulated to serve the poor? What kind of regulation is best suited to ensure that microfinance is able to achieve financial inclusion, and who should be this regulator?

Vikram Akula, the founder of SKS Microfinance claims that "the path of the capital markets will lead to the greatest social impact".⁹ Critics though, most notable among whom is Mohammad Yunus, argue that by offering

² RESERVE BANK OF INDIA MASTER CIRCULAR ON MICRO CREDIT, RBI/2010-11/407; RPCD. FID. BC. No. 53/12.01.001/ 2010-11, February 14, 2011, available at http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=6266 (Last visited on March 16, 2012).

³ BRIGET HELMS, ACCESS FOR ALL BUILDING INCLUSIVE FINANCIAL SYSTEMS 2 (2006).

⁴ Roy Mersland & Reidar Øystein Strøm, *Performance and Corporate Governance in Microfinance Institutions* 1 (Munich Personal RePEc Archive, Paper No. 3887, 2007).

⁵ See Mukul Asher & Savita Shankar, *As Microfinance Grows, So Does The Need For Better Regulation*, March 17, 2010, available at http://www.dnaindia.com/money/comment_as-microfinance-grows-so-does-the-need-for-better-regulation_1359900 (Last visited on March 18, 2012).

⁶ *Id.*

⁷ *Id.*

⁸ CRISIL, INDIA TOP 50 MICROFINANCE INSTITUTIONS (2009), available at http://www.crisil.com/pdf/ratings/CRISIL-ratings_india-top-50-mfis.pdf (Last visited on March 26, 2012).

⁹ Interview of Vikram Akula, founder and CEO of SKS Microfinance by India Knowledge@Wharton, May 1, 2008, available at <http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4284> (Last visited on April 21, 2011).

an IPO buyers get the message that profit can be made out of poor people.¹⁰ “This would push microfinance in the loan-sharking direction,” says Yunus, who has, for the past one year been contradicting Akula’s stance¹¹ by saying that microfinance is, primarily, banking and therefore, MFIs need to work towards obtaining banking licenses, which will enable them to take deposits from the public and thereby become self-sustaining.¹² Mohammad Yunus’ critique about microfinance transforming into loan-sharking has come true in painful circumstances. Vikram Akula himself has accepted that 17 out of the 30 suicides in Andhra Pradesh were due to the interest rates imposed by SKS Microfinance.¹³

In light of these developments we contend that the commercialisation of MFIs needs to be deterred. A corollary arising out of this would be to allow MFIs to exist only as not-for profit institutions as envisaged under § 25 of the Companies Act. Alternatively, if the argument put forward by the promoters of *SKS Microfinance* is tenable, independent regulator(s) must be introduced backed by sound guiding legislation. This paper aims to put forth suggestions for the creation of precisely such a regulatory body. Part II of the paper assesses the limitations of the existing regulatory framework for microfinance institutions (“MFIs”). The section traces the significant pointers in the regulatory mechanism, parameters that assess them and the role of allowing profit in MFIs. Part III of the paper deals with the creation of a possible structure for regulating the MFIs and the possibility of a single regulatory body. Part IV would evaluate the proposed Microfinance Bill by the Ministry of Finance in light of the parameters set out.

II. LIMITATIONS OF THE EXTANT LEGAL REGIME

A. BACKGROUND

Out of the population of 1.2 billion in India at present, it is estimated that 28% are poor.¹⁴ Seeing the past trends of migration to urban areas, a large number of the poor reside in the rural areas. The demand for credit

¹⁰ Erika Kinetz, *SKS Launches India’s First Microfinance IPO*, July 28, 2010, available at <http://abcnews.go.com/Business/wireStory?id=11270209> (Last visited on April 21, 2011).

¹¹ *Id.*

¹² Mohammad Yunus, Founder and Managing Director, Grameen Bank at Clinton Global Initiative, Annual Meeting, 2010, *Special Session: Profiting from the Poor? A Discussion on Microfinance IPOs* available at http://www.clintonglobalinitiative.org/ourmeetings/2010/meeting_annual_multimedia_player.asp?id=83&Section=OurMeetings&PageTitle=Multimedia (Last visited on March 12, 2012).

¹³ Indian Express, *Post-suicides, SKS Microfinance willing to cut loan rates*, October 15, 2010, available at <http://www.indianexpress.com/news/postsuicides-sks-microfinance-willing-to-c/698154/> (Last visited on March 18, 2012).

¹⁴ WORLD BANK, REPORT ON POVERTY PROGRAMMES IN INDIA, September, 2010, available at <http://www.worldbank.org.in/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/INDIA>

amongst the poor is large and heterogeneous.¹⁵ Another important aspect to be noted is that it is this portion of the population that places significant reliance on agriculture as an occupation. It is this section of the population that forms the predominant clientele of MFIs.

Over the years with significant state intervention commercial financial institutions reached out to these people,¹⁶ yet informal financial services have been preferred to institutions such as banks.¹⁷ Unlike, MFIs in Bangladesh and Latin American countries such as Bolivia, which have found considerable success, the Indian institutions have not catered to their expected clientele as comprehensively. Factors such as credit indiscipline and rent-seeking behaviour shown by the institutions in light of stringent regulation have been considered as contributory to such a pattern.¹⁸ But before putting forth arguments in favour of the hypothesis, it is imperative to understand the institutional structure of MFIs in India under the commercial laws at the moment and the defects inherent in them.

On a broad classification there are two models of microfinance in India, viz., Self Help Group-bank linkage model (‘the SHG-bank model’) and the MFI model. Given below is a brief outline of both the models.

1. SHG-Bank Linkage Model

Under this program, NGOs and banks collectively interact with potential clients to form small homogenous groups.¹⁹ The most significant feature of such a system is that it allows for opening of bank accounts in the name

EXTN/0,,contentMDK:20195738~pagePK:141137~piPK:141127~theSitePK:295584,00.html (Last visited March 12, 2011).

¹⁵ Hema Bansal, *SHG-Bank Linkage Program in Indian: An Overview*, 5(1) JOURNAL OF MICROFINANCE 21, 23 (2003).

¹⁶ It is estimated that semi-formal and formal financial services through agricultural cooperatives and banks are within physical reach (less than 5 km) of perhaps 99 percent of the population of the country. See Sa-Dhan – Association of Community Development Finance Institutions, *Existing Legal and Regulatory Framework for the Microfinance Institutions in India: Challenges and Implications*, 2006, available at <http://www.sa-dhan.net/Adls/Microfinance/Article/Publications/ExistingLegalRegulatoryFramework.pdf> (Last visited on February 15, 2012).

¹⁷ Informal sector lenders remain a strong presence in rural India, delivering finance to the poor: the RFAS, 2003 finds that 48 percent of landless and marginal farmers borrowed from an informal source at least once in the past 12 months, at rates averaging 48 percent per year. See Priya Basu & Pradeep Srivastava, *Scaling-up Access to Finance for India’s Rural Poor 2* (World Bank, South Asia Region, Finance and Private Sector Development Unit, Policy Research Working Paper 3646, 2004).

¹⁸ *Id.*

¹⁹ These groups are educated in small-scale fiscal management with initiatives such as collection of small thrift amounts from members and maintenance of accounts. The impetus is given to group of people who belong to the same socio-economic background in order to ensure that the aim of peer support is maintained.

of the entire group. This reduces transaction costs for banks significantly.²⁰ Recovery of loans is based on peer review, the returns are empirically found to be higher.²¹ Furthermore, such a setup saves the members from usurious debt traps and strengthens decision-making and fund management within their groups.²² Gradually, as the pooled thrift grows, they are ready to receive external funds in multiples of their group savings.²³

Presently, commercial banks, co-operative banks and Regional Rural Banks ('RRBs') are actively engaged in the programme. As on March 31, 2007, 50 commercial banks, 96 RRBs and 352 co-operative banks were participating in the programme.²⁴ The number of bank branches (as per the last available data) lending to SHGs was 35,294 at end-March 2006 and the number of participating NGOs and other agencies was 3,024.²⁵

2. MFI Model

Microfinance in India suffers from severe semantic difficulties. Microfinance is defined not by form but by the intent of the lender.²⁶ Therefore, a loan given by a market intermediary to a small borrower is not seen as micro-finance. When an institution whose constituent intent is the distribution of such loans gives a similar loan, however, it is treated as microfinance.²⁷ The institution may be constituted as a society, NGO or a company (profit or not for profit).

The MFI model can be divided into examples which are state initiatives and private ones. National Bank for Agriculture and Rural Development ('NABARD') and Small Industries Development Bank of India ('SIDBI') are examples of state run MFIs. Besides, supporting small-scale financial institutions, commercial banks, RRBs, and co-operative banks provide separate retail services as well.²⁸ The last decade has seen the emergence of private players

²⁰ Hans Deiter Seibel, *SHG Banking: A Financial Technology for Reaching Marginal Areas and the Very Poor*, (IFAD Rural Finance, Working Paper No. 167910, 2001).

²¹ Lykke E. Andersen & Nina Osvaldo, *Micro-Credit and Group Lending: The Collateral Effect* (University of Aarhus, Department of Economics, Working Paper No. 1998-18,1998) as cited in Thierry Van Bastelaer, *Imperfect Information, Social Capital and the Poor's Access to Credit* 13 (Centre for Institutional Reform and the Informal Sector, Working Paper No. 234, 2000).

²² See Hema Bansal, *supra* note 15.

²³ MS Sriram & Rajesh Upadhyayula, *Transformation of the Microfinance Sector in India, Experiences, Options, and Finances*, 6(2) JOURNAL OF MICROFINANCE 88, 104 (2004).

²⁴ For the last available numbers on Microfinance Institutions, see Reserve Bank of India, Report on Currency and Finance, 2006-08, available at <http://rbi.org.in/scripts/AnnualPublications.aspx?head=Report%20on%20Currency%20and%20Finance> (Last visited on March 14, 2012).

²⁵ *Id.*

²⁶ Sriram & Upadhyayula, *supra* note 23.

²⁷ *Id.*

²⁸ Today, there are about 60,000 retail credit outlets of the formal banking sector in the rural areas comprising 12,000 branches of district level cooperative banks, over 14,000 branches of the Regional Rural Banks (RRBs) and over 30,000 rural and semi-urban branches of

dealing solely in the microfinance industry. These institutions provide services that are similar to the state players' under the aegis of the prevailing legal and regulatory environment for private sector rural and microfinance operators. For the purpose of this paper, we intend to focus on the commercialization of this model and the regulation of the aforesaid private players.

B. REGULATORY STRUCTURE IN PLACE IN INDIA

There have been many innovative initiatives undertaken by Indian MFIs over the past five to seven years. The efficacy of such initiatives has, however, been limited. Their operations have faced hurdles by the absence of a supportive regulatory environment. Here, we take a look at the regulatory structure for MFIs in three distinct phases, viz. prior to the Andhra Pradesh MFI crisis of 2010, the state response and the present regulations in light of the recommendations made by the Malegam Committee.

1. Recognising the MFI Players, Prior to 2010

The foremost problems prior to the major crisis that hit MFIs in 2010 are the processes of registration involved. There is a multitude of ways to form and register a private MFI.²⁹ In the absence of an umbrella regulatory mechanism regulation of MFIs has become an example of too many cooks spoiling the broth. The problem is that registering the MFI under each of the categories invokes different legislations to govern the MFIs. Despite a similar set of services being provided, there seems to be an inconsistency with the regulations governing the bodies. The table³⁰ below provides the seven categories recognised³¹ by the RBI and the legal framework that governs their activities.

commercial banks besides almost 90,000 cooperatives credit societies at the village level. The numbers show a significant outreach. On an average, there is at least one retail credit outlet for about 5,000 rural people. See National Bank for Agriculture and Rural Development, *mF Institutions*, available at http://www.nabard.org/microfinance/mf_institution.asp (Last visited on March 14, 2011).

²⁹ Pradeep Srivastava, *Microfinance in India: Odysseus or Interloper*, 40(33) *ECONOMIC & POLITICAL WEEKLY* 3626, 3627 (2005).

³⁰ Reserve Bank of India, *Frequently Asked Questions*, available at <http://www.rbi.org.in/scripts/FAQView.aspx?Id=7> (Last visited on March 14, 2012).

³¹ It is pertinent to note that recognition is based upon the regulatory body registering the MFI. There are certain MFIs that do not register themselves. It is also pertinent to note that there is no mechanism that makes the registration of MFIs compulsory unless the regulating legislation mandates it.

S.No.	Categories of Providers	Legal Framework governing their activities
1.	Domestic Commercial Banks: Public Sector Banks; Private Sector Banks & Local Area Banks	RBI Act 1934 BR Act 1949 SBI Act SBI Subsidiaries Act Acquisition & Transfer of Undertakings Act 1970 & 1980
2.	Regional Rural Banks	RRB Act 1976 RBI Act 1934 BR Act 1949
3.	Co-operative Banks	Co-operative Societies Act BR Act 1949 (AACS) RBI Act 1934 (for sch. banks)
4.	Co-operative Societies	State legislation like MACS
5.	Registered NBFCs	RBI Act 1934 Companies Act 1956
6.	Unregistered NBFCs	NBFCs carrying on the business of a financial institution prior to the coming into force of RBI Amendment Act 1997 whose application for CoR has not yet been rejected by the Bank Sec. 25 of Companies Act
7.	Other providers like Societies, Trusts, etc.	Societies Registration Act, 1960 Indian Trusts Act Chapter IIIC of RBI Act, 1934 State Moneylenders Act

For the purposes of this paper we would be focusing at institutions registered under categories 5, 6 and 7 above which would come within the ambit of private MFI models. These include the Non Banking Finance Companies ('NBFCs'), Moneylenders, and Societies and Trusts that provide microfinance services. The basis of making such a selection is that any argument made in the context of commercialisation is built on the ability of these individuals/institutions to carry out their activities for profit.

2. The Andhra Pradesh Crisis and the chinks in the Regulatory Armour

Andhra Pradesh has the highest concentration of MFIs and the largest exposure through the SHG-Bank linkage model. The state itself

contributes a fourth of the Rs. 30,000 crore sector.³² The 2010 crisis was not the first time that the state faced such a problem.³³ The question to be answered is that is closing down of errant MFIs in the absence of adequate regulatory guidelines warranted? The ordinance (and the later analogous legislation) passed by the Andhra Pradesh Government shifted the discourse from the basic problem to a legal frame. The Andhra Pradesh Government though, already had the *Indira Kranti Patham* scheme in place. In such a scenario the state government in addition to the role of a regulator also plays the role of a service provider. This is highly similar to making NABARD the regulator for MFIs.³⁴

The ordinance (and later the legislation) passed by the Andhra Pradesh government makes no distinction between errant institutions and the rest. It seems that there is no rational nexus between the intention of the legislation and the outcome. Given that the state is itself a dominant player in this market, this heavy handedness creates an undesired competitive barrier to an alternate model of credit delivery. This almost appears like the government taking revenge on the competition with its monopolistic regulatory power.³⁵ Furthermore, with the state government taking such actions the MFIs are caught between the extant norms of the RBI and the ones placed by the state government.³⁶ Instead of harping on caps on interest rates and threatening to remove microfinance from the priority sector list, it is necessary for the State/ Reserve Bank of India to look at specific instances and pull up the delinquent organisations.³⁷ But amidst such criticisms the question is what can be done in terms of regulating MFIs?

3. The Malegam Committee Response

The Andhra Pradesh microfinance crisis of 2010 led to an acceptance of the need for more rigorous regulation of NBFCs functioning as MFIs.³⁸ Critiques in the media while outlining the issues that the committee should deal

³² Hindu Business Line, *AP MFIs caught between RBI and State Govt. Norms*, May 8, 2011, available at <http://www.thehindubusinessline.com/industry-and-economy/economy/article2001365.ece> (Last visited on March 12, 2012).

³³ Usurious interest rates caused the state to close down nearly 50 branches of 2 MFIs in the state in March 2006. See H.S. Shylender, *Microfinance Institutions in Andhra Pradesh: Crisis and Diagnosis*, 41 Economic & Political Weekly 1959 (2006).

³⁴ See *infra* note 110.

³⁵ M.S. Sriram, *Microfinance: A Fairyrtale Turns into a Nightmare*, 45(43) ECONOMIC & POLITICAL WEEKLY 10, 13 (2010).

³⁶ Business Standard, *MFIs caught between RBI and AP Govt norms*, May 8, 2011, available at <http://www.business-standard.com/india/news/mfis-caught-between-rbiap-govt-norms/134386/on> (Last visited on March 19, 2012).

³⁷ Sriram, *supra* note 35.

³⁸ See RESERVE BANK OF INDIA, REPORT OF THE SUB-COMMITTEE OF THE CENTRAL BOARD OF DIRECTORS OF RESERVE BANK OF INDIA TO STUDY ISSUES AND CONCERNS IN THE MFI SECTOR, ¶3.4, available at <http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/YHMR190111.pdf> (Last visited on March 18, 2012).

suggested that the rush to rake in profits should be dealt with a heavy hand.³⁹ The mandate for the committee was extremely clear to the extent that if need arises then the entire regulatory mechanism may be overhauled.⁴⁰ Though, one of the significant steps taken by the committee was an attempt to demarcate jurisdictional overlaps in the applicability of legislations and regulatory controls exercised by the RBI.⁴¹ The Committee, *inter alia*, recommended:⁴²

- a. Creation of a separate category of NBFC-MFIs;
- b. A margin cap and an interest rate cap on individual loans;
- c. Transparency in interest charges;
- d. Lending by not more than two MFIs to individual borrowers;
- e. Creation of one or more credit information bureaus;
- f. Establishment of a proper system of grievance redressal procedure by MFIs;
- g. Creation of one or more “social capital funds”; and
- h. Continuation of categorisation of bank loans to MFIs, complying with the regulation laid down for NBFC-MFIs, under the priority sector.

It is important to note at this juncture that despite a very clear mandate at the beginning the Malegam Committee in its final recommendations was finally bound by separation of power conflicts. The fact that issues of money lending and cooperatives are state subjects any proposed legislation by the Parliament would be *ultra vires*.⁴³ As such the committee could not provide a concrete answer to the jurisdictional conflict that may arise in relation to MFIs whose operations overlap between union and state subjects. The committee further suggests a way out of the conflict by seeking that states make suitable changes to laws that allow for a mandate that there would be a greater coordination with the RBI.

³⁹ See Swaminathan S. Anklesaria Aiyar, *Issues for the Malegam Committee*, December 8, 2010, available at http://articles.economictimes.indiatimes.com/2010-12-08/news/27632463_1_shgs-andhra-pradesh-ordinance-mfis, (Last visited on March 18, 2012).

⁴⁰ RESERVE BANK OF INDIA, *supra* note 38.

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*, ¶24.7.

4. The Stringent RBI Response

The RBI has in effect now accepted the regulatory recommendations made by the Malegam Committee.⁴⁴ In absence of any statutory guidance the RBI introduced directions for a distinct category, i.e. NBFCs dealing in Microfinance.⁴⁵ An analysis of the measures introduced by the RBI would suggest a clear shift towards bringing the MFIs under the purview of prudential regulation norms. The most important classification made by the notification is the creation of the NBFC-MFI category. Such a categorisation clearly creates a distinction between deposit taking and non-deposit taking NBFCs that deal with lending services in particular. Among other things, a minimum Net Owned Fund requirement has been placed at Rs. 5 crore. The assertion that MFIs are being brought under the purview of prudential regulation norms is based on enhanced capital requirements, asset classification & provisional norms. There is a clear aim to protect interests of those persons who seek loans from MFIs as an alternative to moneylenders by ensuring parity.

C. PARAMETERS REFLECTING THE LIMITATIONS

With the present regulatory structure being outlined we seek to look at the first limb of the argument put forth in this paper - that commercialisation of MFIs in India should be deterred under the regulatory mechanism. *SKS Microfinance* is the most dominant MFI in India.⁴⁶ Since, it has issued an IPO; its data is already publicly available. Our argument is based upon the flaws that have fuelled the criticisms around the transactions made by *SKS*.

The *first* such parameter is the lack of adherence to corporate governance. The companies that are adopting the commercial approach can more or less be read under the ambit of the Companies Act, 1956.⁴⁷ Thus, by means of internal regulation, strong corporate governance is a must. Critics to the commercialisation process feel that the ‘celebration of the market endorsement’ of this business was ill-timed.⁴⁸ While exhibiting an eagerness to issue IPOs and glorifying its apparent success, MFIs have failed to show a linkage between the top and bottom of the pyramid at the institutional level.⁴⁹ The Ministry of

⁴⁴ See Dr. D. Subba Rao, Governor, RBI, *Monetary Policy Statement, 2011-12*, available at <http://rbi.org.in/scripts/NotificationUser.aspx?Id=6376&Mode=0> (Last visited on March 17, 2012).

⁴⁵ See RESERVE BANK OF INDIA, NOTIFICATION ON THE INTRODUCTION OF NEW CATEGORY OF NBFCs - ‘NON BANKING FINANCIAL COMPANY-MICRO FINANCE INSTITUTIONS’ (NBFC-MFIs) – DIRECTIONS, December 2, 2011 available at <http://rbi.org.in/scripts/NotificationUser.aspx?Id=6857&Mode=0>, (Last visited on March 17, 2012).

⁴⁶ M.S. Sriram, *Commercialisation of Microfinance in India: A Discussion of the Emperor’s Apparel*, 45(24) ECONOMIC & POLITICAL WEEKLY 65, 70 (2010).

⁴⁷ See Categories 5&6 of the RBI table, *supra* note 30.

⁴⁸ *Id.*

⁴⁹ See Sriram, *supra* note 35, 13.

Corporate Affairs mandates that boards of every company have to ensure the presence of risk management frameworks which are reviewed semi-annually.⁵⁰

The second parameter has to be Risk Management in light of the Operational Risks that have been posed in the sector. Basel II norms define such risks as “the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events”.⁵¹ Such a definition has been interpreted to mean that directors should establish a robust system designed to identify and evaluate potential risks in every aspect of the business operation.⁵² The fact that has to be realised foremost is that breakdown in non-financial areas could have significant financial repercussions for companies.⁵³ The *SKS Microfinance* controversy provides glaring examples of the same. With clients committing suicides at the ground level and no sight of returns clients, the institution exerted excessive pressure at the ground level on the clients. Therefore, there has been a clear absence of a risk management mechanism. If such a mechanism would have been in place then why weren't any options in play in event of slow/inadequate returns? At the institutional level, it appeared that the boardroom battles were all about stock options, cashing in, cashing out and severance packages, when each of the boards should have been discussing whether their business model was showing cracks.⁵⁴ Such a scenario is against the ethical fabric that is woven in through corporate governance.

The *third* parameter is the *role of capital requirements*. As has been asserted above the new RBI notification shows a shift towards bringing the MFI institutions under the gamut of prudential regulation norms. Capital requirements are one of the most important criteria. Sufficient capital would be the need of any institution that provides lending services. The adoption of the Basel Accords has led to a consensus that there have to be certain minimum capital requirements.⁵⁵ Drawing from the experience of successful MFIs in Latin America, any institution that has to achieve stability has to have a minimum capital of US\$2 million (approximately 10 crore) and an existing portfolio

⁵⁰ See Risk Management, Corporate Governance Voluntary Guidelines, 2009, Heading II.C.

⁵¹ See BASEL COMMITTEE ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT ON OPERATIONAL RISK, SUPPORTING DOCUMENT TO THE NEW BASEL CAPITAL ACCORD, January, 2001, available at <http://www.bis.org/publ/bcbsca07.pdf> (Last visited on March 17, 2012).

⁵² See Lynn Drennan & Matthias Beck, *Corporate Governance: A Mandate for Risk Management?*, available at www.nottingham.ac.uk/business/cris/ukec/2001paper4.doc, (Last visited, March 12, 2012).

⁵³ Richard Anderson, OECD, *Risk Management and Corporate Governance*, available at www.oecd.org/dataoecd/29/4/42670210.pdf (Last visited on June 8, 2011).

⁵⁴ Sriram, *supra* note 35. (Sriram further states that the promoters have gotten away with significant instances of skimming and there seems to be no dissent voiced on the greedy executive compensations and short-sighted behaviour of the management of the top MFIs).

⁵⁵ BASEL COMMITTEE ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK, June 2004 (also known as the Basel-II accords).

of US\$ 10 million (Rs. 45 crore).⁵⁶ This has been termed as necessary for financial stability.⁵⁷ In India the limit for NBFCs was initially placed at Rs. 2 crore.⁵⁸ This has been raised by the new notification to Rs. 5 crore, which may still be considered to be below par.

Further, NGOs and trusts cannot hold equity positions in NBFCs. So, portfolio building becomes difficult. MFIs generally seem to partner banks in order to achieve outreach. The banks fulfil these minimum capital requirements. In scenarios for MFIs which do not get partner banks, the room is open to seek money from the public. This method was adopted by *Banco Compartamos* in Bolivia and *SKS Microfinance* in India. The biggest flaw of this method is that it requires profitable returns to the investors. Though, there is nothing wrong legally for fulfilling capital requirements from the open market, it needs to be understood that for an institution which is dealing with lending to small scale loan seekers, the returns cannot be as frequent to show growth to the satisfaction of the investors. Assuming that MFIs are allowed to go to the market, a suitable amendment to the Companies Act is needed. Such an amendment should place higher capital requirements for MFIs that seek to go public.

The *fourth* and the last parameter is the leverage of *interest rates and means of recovery*. Mohammad Yunus critiqued that commercialization would plunge MFIs into loan sharking.⁵⁹ *Prima facie* it seems that his allegations bear substance. The capital inflow for MFIs includes funds from banks and the open market where the rate of interest would be at 12%. Mohammad Yunus points out that any rate in microfinance lending above the rate of 15% falls in the arena of loan sharking.⁶⁰ The loans lent out by Indian MFIs range between 24 to 32%.⁶¹ The criticism is that saying finally MFIs were replacing the usurious moneylenders in villages.⁶² Those who defend the MFIs state that the criticism is unfair as empirical evidence abroad points otherwise as the returns on the loans are as high as 96%.⁶³ In the Indian scenario, however, the criticism does not stop there. It is not just the unregulated interest rates but also

⁵⁶ See Reinhard Schmidt, *supra* note 1.

⁵⁷ *Id.*

⁵⁸ RESERVE BANK OF INDIA, DEPARTMENT OF NON-BANKING SUPERVISION, NOTIFICATION ON MINIMUM NET OWNED FUND (NOF) FOR COMMENCEMENT OF BUSINESS OF A NON-BANKING FINANCIAL INSTITUTION (NBFI), DNBS (PD) No. CC.10/02.59/98-99, April 20, 1999 (effective from April 23, 1999).

⁵⁹ See Kinetz, *supra* note 10.

⁶⁰ Jaideep Hardikar, *Microfinance Institutions are a menace*, January 2, 2011, available at http://www.dnaindia.com/money/report_microfinance-institutions-are-a-menace_1489045 (Last visited on March 15, 2012).

⁶¹ Shishir Arya, *No Cap on MFI Interest Rates*, February 16, 2011, available at http://articles.timesofindia.indiatimes.com/2011-02-16/india-business/28551759_1_mfis-lending-rates-credit, (Last visited on March 19, 2012).

⁶² *Id.*

⁶³ The Economist, *Overcharging: Microlending is under attack, unfairly*, November 18, 2010, available at <http://www.economist.com/node/17522350> (Last visited on March 19, 2012).

the means to recover them. A large part of the criticism in Andhra Pradesh has been the harassment that recovery agents inflicted on the poor farmers.⁶⁴ The Supreme Court has reiterated that harassment by recovery agents warrants criminal action.⁶⁵ The Court has reaffirmed the role of guidelines by the Reserve Bank of India for loan recovery made by banks.⁶⁶ In the case of MFIs, however, such guidelines have never existed. Even the Malegam Committee has suggested that the limit to interest rates be kept at 24% which is still a considerable 9% higher than what Prof. Yunus suggested.⁶⁷ The question would be thus, is the new mechanism supporting loan sharking methods?

The four parameters listed herein have a crucial bearing in the determination of the motive of making profits that an MFI may have. We have already pointed out that the lack of corporate governance has been one of the causes for cracks in the institutional structure of the MFIs. Critics point out that the relationship of sound governance within MFIs and the interest rates that they are applying seem lopsided. Poverty alleviation thus, may just be an illusion and such rates are exploiting and over-indebting poor customers for profit motives.⁶⁸ Further, one of the criticisms to SKS was that as soon as the IPO generated sufficient capital, most of the managerial employees cashed out. The nature and purpose of the capital generated demands a look into the cashing out opportunities. As the company is asking newer investors (including retail investors) to invest in the company, all the senior executives are encashing their own stakes indicating – as investors – that this is a good price to exit from the company.⁶⁹ In light of these parameters and the profit making motive that MFIs may have, we now take a look at the role of profit in MFIs.

D. THE ROLE OF 'PROFIT' IN MICROFINANCE: IS IT GOOD OR BAD?

Microfinance lending is primarily a development initiative. It is only in the recent times that a certain sense of commercial viability has been associated with it. The voluntary development agencies (or NGOs) who were registered either as societies, trusts or § 25 companies, did not think of looking at alternative institutional forms for providing these services.⁷⁰ Having a § 25 company adds to the leveraging capacity of the institution. This also adds to

⁶⁴ See Sriram, *supra* note 46.

⁶⁵ See *Manager, ICICI Bank Ltd. v. Prakash Kaur*, (2007) 2 SCC 711; AIR 2007 SC 1349, See also *The Hindu, Banks can't hire Goondas for Loan Recovery: Court*, February 7, 2007, available at <http://www.hindu.com/2007/02/07/stories/2007020704121300.htm> (Last visited on March 12, 2011).

⁶⁶ *Id.*

⁶⁷ See RESERVE BANK OF INDIA, *supra* note 38, ¶7.11.

⁶⁸ Jessica Shicks, *Microfinance Over-Indebtedness: Understanding its drivers and challenging the common myths* (Emile Bernheim Working Paper Series, Paper No. 10/048, 2010).

⁶⁹ See Sriram, *supra* note 35, 66.

⁷⁰ See Bansal, *supra* note 15.

the credibility of the commercial financial institutions that are willing to lend to the sector.⁷¹ Advantages include tax exemptions under the Income Tax Act.⁷² The most important aspect of being a § 25 company is that there is no need to register with the RBI as § 25 companies are not NBFCs. This advantage has been extended even under the new notification issued by the RBI as it extends purely to NDFCs. This reduces the regulatory burden. There is a cap on the amounts provided out as loans. As the scale of operations of microfinance activities started growing and, along with that, the desirability of undertaking such activity on a for-profit basis started coming into focus, the larger institutions started to feel the need for a transformation in their legal structure.

With the advent of private institutions, any argument for/against commercialization of the sector is based on their intent to make a profit. The Association of Community Development Finance Institutions argues that an overtly commercial approach, albeit with sufficient regulation is institutionally more sustainable.⁷³ This approach to microfinance in India is the establishment of a for-profit company followed by registration with the RBI as an NBFC. A number of MFIs are considering this route and a few have either already transformed into NBFCs or are in the process of doing so.⁷⁴ The key factor is that the RBI regulates only those microfinance institutions which are registered with it as NBFCs. Further, there is a regulatory gap between the way the RBI regulates NBFCs and normal banks. Although the registered companies cover over 80 per cent of the microfinance business, in terms of number of companies they constitute a small percentage of the total number of MFIs in the country. The RBI, however, does not prescribe lending rates for these institutions.⁷⁵ A scepticism that exists is that registering as not-for-profit companies under § 25 of the Companies Act, is to take advantage of the RBI's exemption from registration for such companies providing microfinance services.⁷⁶

In this light when we take a look at the new regime being brought into place by the Malegam Committee Report and the RBI, we can actually see support for the concerns raised above because, there is no adequate nexus between such concerns for the shift that the industry is seeing at the moment and the regulatory measures undertaken. Though, it may seem that the above regulatory concerns have been answered, there is still a lack of a supervisory

⁷¹ *Id.*

⁷² *See* Income Tax Act, 1956, §25-1A.

⁷³ *See* Bansal, *supra* note 15.

⁷⁴ *Id.* Notable examples of these include the Cashpor Microcredit Company Ltd (CMC), based at Varanasi and operating in the eastern part of Uttar Pradesh and western Bihar, and Sanghamithra Rural Financial Services Limited (SRFS) based at Bangalore, operating in Karnataka. These, however, are still relatively few in number, perhaps no more than ten.

⁷⁵ Press Release, RESERVE BANK OF INDIA, *RBI Sub Committee of the Central Board of Directors to study Issues and Concerns in MFI Sector*, October 28, 2010, available at <http://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/IEPR591S1010.pdf> (Last visited on May 1, 2011).

⁷⁶ Sriram, *supra* note 35, 13.

mechanism set out by the RBI. Thus, in relation to NBFC-MFIs the approach taken by the RBI may seem a little short-sighted.

2010 was considered to be the year when Indian MFIs were supposed to come of age as SKS Microfinance launched its IPO. Optimists hoped that an infusion of private capital would spur even greater growth in credit to India's rural poor, nearly 27 million of whom are already microfinance clients.⁷⁷ The biggest criticism that the infusion of private capital has received is that by way of IPOs, the focus of the MFIs would shift from public good to profit making to show returns to the shareholders.

It is stated that 65 of the world's top microfinance issuers got an average rate of return of 2.5% of total assets, which is comparable to returns in the commercial banking sector.⁷⁸ MFIs are thus, without doubt a lucrative business opportunity. But, it needs to be noted that microfinance loans typically range around \$100. This is not enough money to provide stability while also keeping recipients working in subsistence-level trades.⁷⁹ Let us for example take the case of *Banco Compartamos*. *Banco* provided loans as an MFI to clientele consisting of mostly women. The clients were pooled into groups on the basis of the loan taken. Unlike non-profit institutions which reinvest the money earned to expand the organization's reach *Banco* is a public company where returns are answerable to the shareholders.⁸⁰ The major debate around the public issue of *Banco Compartamos* became strikingly similar to the profit motives that have been witnessed with *SKS Microfinance*. Excessive interest being charged to the poor and appropriation of offering for sale the shares of the existing shareholders without an expansion of the capital at the time of the public offering have been the parameters because of which *SKS Microfinance* has drawn flak as well. On a whole such criticism has been propelled at any MFI that has sought to earn a profit. As such the whole profit making motive has to be seen in a negative light. Perhaps, with adequate regulation by the state a way out may be discovered.

Such hopes are dashed under the existing legal framework. There is no adequate mechanism for MFIs that seek to issue securities in the open market despite existing securities laws. Thus, only the interest of the shareholders in the MFIs would be taken care of. Thus, in our opinion the impetus of protection rendered by relevant laws is imbalanced. The blame though, cannot be rested adequately on any specific regulatory body as such since issuance of IPOs is perfectly legal under the existing securities and banking laws.

⁷⁷ The Economist, *Discredited: A string of suicides puts microlending under the spotlight*, November 4, 2010, available at <http://www.economist.com/node/17420202> (Last visited on March 19, 2012).

⁷⁸ Gregory Gethard, *Microfinance: Philanthropy through Industry*, available at <http://www.investopedia.com/articles/economics/08/microfinance.asp> (Last visited on March 13, 2012).

⁷⁹ *Id.*

⁸⁰ See Sriram, *supra* note 46, 66.

III. HOW TO REGULATE MICROFINANCE INSTITUTIONS

With the limitations of the mechanism being highlighted above, it is imperative to look at the possible avenues where the legal lacunae may be filled. In addition to the Malegam Sub-Committee, the RBI setup a separate working group to look into the regulation of microfinance institutions on March 8, 2011.⁸¹ The problem it seems is that there are too many regulators as there are varied ways to initiate a MFI in India. Fitch Rating, one of world's leading rating agencies, recognises that the challenges faced by MFIs in India are similar to the global trend which includes regulatory concerns.⁸² "The experience of co-operative banks in India suggests that multiple regulators may not be as effective as a single strong regulator and may also make it difficult for MFIs to comply with different sets of guidelines."⁸³ Hartarska points out that that supervision in the sector by central banking authorities does not affect either sustainability or outreach.⁸⁴ The rider, however, being that such an observation does not apply to scenarios where institutions lay emphasis on sustainability and outreach along with returns on the investments made.⁸⁵ The argument though put forth was that there should be governmental regulation for deposit acceptors.

Any approach to regulation and supervision of MFIs needs to recognize their heterogeneity, and accommodate the flexibility and scope for development that MFIs need.⁸⁶ The specific problems posed by the regulation of MFIs are an outgrowth of the fact that, almost by their very nature, these institutions are highly specialised.⁸⁷

⁸¹ The panel was headed by RBI Deputy Governor, Usha Thorat in light of the Malegam Sub-Committee Report. See Business Standard, *RBI working group under Thorat to study NBFC issues*, March 8, 2011, available at <http://www.business-standard.com/india/news/rbi-working-group-under-thorat-to-study-nbfc-issues/427608/> (Last visited on March 18, 2011).

⁸² The Economic Times, *Microfinance companies needs stable regulation to survive: Fitch*, April 28, 2011, available at http://articles.economicstimes.indiatimes.com/2011-04-28/news/29482804_1_fitch-microfinance-companies-india-s-mfis (Last visited on March 13, 2012).

⁸³ See *id.* See also Interview of Ananda Bhoomik, Senior Director (Financial Institutions), Fitch Ratings in the Economic Times, *Microfinance companies needs stable regulation to survive: Fitch*, (April 28, 2011), available at http://articles.economicstimes.indiatimes.com/2011-04-28/news/29482804_1_fitch-microfinance-companies-india-s-mfis, (March 26, 2012).

⁸⁴ Valentina Hartarska, *Governance and Performance of Microfinance Institutions in Central and Eastern Europe and the Newly Independent States* 13 (William Davidson Institute Working Paper Series, Paper No. 677, 2004).

⁸⁵ *Id.*

⁸⁶ Daniel C. Hardy, Paul Holden & Vassili Prokopenko, *Microfinance Institutions and Public Policy* 20 (IMF Working Paper No. WP/02/159, 2002).

⁸⁷ At least when they start their operations; they employ credit technologies which are specially designed for their target groups; they rely on close personal relationships with their clients as a substitute for conventional forms of collateral; and they have a specific governance and

The regulation of MFIs is broadly two-fold. At one end there are non-profit institutions which provide specific services and only lend out donor funds. It is believed that MFIs must be introduced to prudential norms in a gradual manner.⁸⁸ Though, they may still be subject to other regulations, for example on record keeping.⁸⁹ The other limb of classification is profit making entities which seek returns. The IMF recommends that such MFIs should be treated as analogous to full-fledged commercial banks.⁹⁰ Thereby, they should be subject to the same prudential regulatory regime as applied to the commercial banks with which they compete.

In intermediate cases, any regulatory framework for MFIs would have to address the trade-off between depositor protection and other benefits of regulation on one hand, and stifling of financial innovation and competition as well as other costs of regulation on the other hand. In many situations, a reasonable compromise between these objectives might be approached by regulations that emphasize that MFIs should be bona fide and should establish adequate internal controls and record keeping (including on loan loss recognition). Regulations also need to be carefully gradated to allow for the development of MFIs from very small, local, and specialized institutions to full-service providers of financial services.

The SHG-Bank Linkage model builds upon the existing institutional infrastructure with civil society participation. Therefore, regulatory issues have been minor and well dealt with by NABARD which regulated them in early phases of the movement.⁹¹ It is, however, the MFI model that has borne the brunt of the lack of adequate regulation. In light of the crackdown by the state these institutions have vociferously demanded legal and regulatory accommodation to create institutional space for them.⁹² In particular, they are unable to access deposits and act as banks due to regulatory barriers and prudential norms dictated by the RBI for entities seeking to act as banks.

A. SUGGESTED REGULATORY FRAMEWORK

The legal, regulatory framework predates microfinance, and thus needs some reorientation to accommodate genuine constraints to expansion of

ownership structure which helps to ensure that they remain committed to their specific clientele, which is admittedly a difficult one to serve; See Schmidt, *supra* note 1, 114.

⁸⁸ B. Seth McNew, *Regulation and Supervision of Microfinance Institutions: A Proposal for a Balanced Approach*, 15 LAW & BUS. REV. AM. 287 (2009).

⁸⁹ *Supra* note 75.

⁹⁰ *Id.*

⁹¹ NABARD, *supra* note 28.

⁹² Alison Granito, *Demand for tighter microfinance Bill, neutral regulator*, August 2, 2007, available at <http://www.livemint.com/2007/08/02003258/Demand-for-tighter-microfinanc.html> (Last visited on March 14, 2012).

MFIs.⁹³ The primary aim of regulation in this sector should be the creation of a ‘level playing field’.⁹⁴ This should not be confused with having the same regulations for all financial institutions alike. The need of the hour is that regulations should cater to a clearly demarcated setup.

1. How to go about establishing a new framework?

At the level of financial institutions Chavez and Gonzalez-Vega distinguish between allocational, operational and dynamic efficiency.⁹⁵ The efficiency of the financial institutions is a measure of the efficiency of the regulatory framework. The gains in efficiency are a function of standardisation. Standardisation may be divided into two forms. Firstly, where regulation allows for reduction in operational costs and secondly, where the individual identity of each organization merges with the other ones. There is a trade off between the objectives of efficiency and stability of the financial system. Measures to safeguard the soundness of the financial system always affect competition and therefore tend to incur efficiency losses. Efficient supervision means maximizing the probability of detecting infringements of regulations.⁹⁶

As far as possible, the regulatory framework for financial institutions should stipulate a governance structure that is incentive compatible, i.e. that makes full use of the self-interest of the individuals (owner, manager, depositor, borrower, etc.), to arrive at the desired results.⁹⁷ This can be particularly important with MFIs, because recourse to legal enforcement mechanisms would be impracticable and too costly due to the informality of the sector. The ownership structure plays a large role here.

The regulatory framework for financial institutions must be flexible enough to be able to react to regulatory avoidance, technological innovation, failures of certain regulatory measures, etc. This is particularly important in microfinance, since hardly any experience is available in other countries. Regulation can be seen as an evolutionary process where individual institutional types or only some elements of their ownership and governance structure prevail and others are superseded. One of the great strengths of unregulated

⁹³ Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH, Stephan Staschen, *Regulation and Supervision of Microfinance Institutions: State of Knowledge*, August 1999, available at http://www.staschen.net/FINANZSYSTEME_Regulierung_State_of_Knowledge_1999e.pdf (Last visited on March 26, 2012).

⁹⁴ Rodrigo A. Chaves & Claudio Gonzalez-Vega, *Principles of Regulation and Supervision: Should They be Different for Microenterprise Finance Organizations?* (Ohio State University Rural Finance Program, Occasional Paper No. 1979, 1992).

⁹⁵ Allocational efficiency is aimed at channelizing the resources to their most productive use. The minimizing of the transaction costs leads to operational efficiency. Dynamic efficiency refers to the adaptability to changing circumstances. The circumstances referred to herein are the ability to stabilize and expand their outreach. See Chavez & Gonzalez-Vega, *id.*

⁹⁶ *Id.*, 34.

⁹⁷ *Id.*, 17.

MFIs till now has been their ability to test innovative products. Hence Merton's argument for functional instead of institutional regulation. The functional perspective takes as given the economic functions performed by financial intermediaries and asks what is the best institutional structure to perform those functions.⁹⁸ In institutional regulation there are different regulatory frameworks that prescribe requirements for certain institutional types (e.g. a banking law alongside cooperatives legislation and a law for finance companies), but these rarely allow for an easy transition from one category to another. There would be enormous transaction costs that would be associated with each transition. Requiring MFIs to keep customary bank loan records for example would incur excessive costs, because they issue a large number of small short-term loans. Similarly, the costs of supervision would be extremely high partly because of the sometimes huge number of MFIs in relation to their national economic significance and the related risk potential, so that banking supervisory bodies are often reluctant to regulate them and lack the requisite resources.⁹⁹ One of the major challenges, then, will be to find cost-saving but effective methods to regulate and supervise MFIs.

2. Capital Requirements

While dealing with suggestions on a regulatory structure and suggestions as to what changes should be brought into regulations we consider foremost the parameters that we perceive contribute to the limitations of the extant regime. In consonance with the Basel Accords there are relative capital requirements obliging banks to have equity or other risk-bearing capital equivalent to a certain proportion of their assets, and, on the other, there are absolute capital requirements in the form of a minimum permissible amount of equity.¹⁰⁰ One of the main ingredients of banking regulation is the requirement that financial institutions must have sufficient capital. This requirement is mainly intended to protect depositors, but also helps to stabilise individual financial institutions and to safeguard the financial system against so-called systemic risks.¹⁰¹ In India, depositor facilities with MFIs are relatively new. Capital requirements are predominantly seen as a measure to ensure stable institutions for lending capabilities. We propose that MFIs specifically, should be subject to higher relative capital requirements than are applied to "normal" banks, combined with strict, and strictly enforced, limitations on the range of activities in which they are permitted to engage. In such a way this would ensure that there is a specific line of funds channelling through to the company and not just

⁹⁸ Robert C. Merton, *A Functional Perspective of Financial Intermediation*, 24(2) FINANCIAL MANAGEMENT 23 (1995).

⁹⁹ Tor Jansson & Mark Wenner, *Financial Regulation and its Significance for Microfinance in Latin America and the Caribbean* (1997) as cited in Staschen, *supra* note 93, 14.

¹⁰⁰ RESERVE BANK OF INDIA, *supra* note 38, ¶21.4.

¹⁰¹ See Schmidt, *supra* note 1, 12.

funds from the open market. In a way this would ensure that unethical practices such as cashing out by MFI managements are curtailed.

3. Creation of credit delivery mechanisms

The second round of focus in light of a new legislation is the creation of credit delivery mechanisms. Financial liberalisation in the 1990s spawned greater entry amongst NBFCs but also saw several instances of illegal behaviour and scams costing millions of rupees to consumers. If entry norms are diluted combined with a weak monitoring infrastructure there exists a risk of consumers getting ripped off.¹⁰² The intrinsic trade-offs between appropriate supervision and regulation of these MFIs and their need to scale up to adequately serve the financial needs of the poor lies at the heart of the debate on regulatory reforms for microfinance. Additionally, creation of such 'micro' banks with different regulatory provisions, diluted entry norms and exemptions from regulations affecting banks will adversely impact existing institutional assets that comprise rural formal financial sector.¹⁰³ Many of these institutions are in precarious health, but others are not and cumulatively represent substantial investments of public resources over years. In a country as large and heterogeneous as ours, there is arguably a need to allow diverse delivery channels of credit for poor to flourish.¹⁰⁴ Given the scale of our failure hitherto to solve the poor's credit problems, it is also advisable to keep an open and flexible stance. Yet history teaches us that when it comes to microfinance, it would make sense to keep expectations modest, monitor alertly and adapt as needed, and, on the legal and regulatory front, stay flexible but make haste slowly.

4. Governance Issues

Governance is scaffold of checks and balances designed to ensure that no party within an MFI impede the attainment of corporate objectives by diverting its resources for private gain.¹⁰⁵ By governance, importance has to be given on the creation of sound internal governance. It is pointed out that with strong initiatives by the managing boards, MFIs achieve higher sustainability.¹⁰⁶ A standard registration requirement which covers documents of establishment and governance structure should apply to MFIs such as NBFCs in the same manner that other business and social organizations are required to register. These basic documents include Articles and Memorandum of Association of the companies which clearly delineate the presence of the governing parties.

¹⁰² Shrivastava, *supra* note 29, 3626, 3628.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ Hennie Van Greunning, Joselito Gallardo & Bikki Randhawa, *A framework for Regulating Microfinance Institutions* (Working Paper for Financial Sector Development Department of the World Bank, 1998).

¹⁰⁶ Shicks, *supra* note 68, 24.

What is necessary in India at the moment is the creation of guidelines for prudential regulation which accommodate MFIs and their needs from time to time. Boards of Directors, who represent the shareholders, members or donors, have the ultimate responsibility and accountability for internal oversight and governance over management in a MFI's operations.¹⁰⁷ This requires that adequate risk management policies and procedures are in place. Clarkson and Deck point out certain characteristics of sound internal governance.¹⁰⁸

- a. A fiduciary responsibility to ensure the financial integrity and soundness of the MFI and safeguard the interests of all of its stakeholders;
- b. A strategic role in designing corporate strategy by considering the principal risks faced by the institution, and reviewing and approving the business plans formulated by management in the context of the MFI's mission;
- c. A supervisory function in delegating to management appropriate operating authorities and approval limits, and supervising its execution of the business plan; and
- d. A management development responsibility for selection, evaluation and compensation of the senior management team, including succession planning for the MFI's chief executive and other key officers.

5. High rates of interests

In light of the *SKS Microfinance controversy* in Andhra Pradesh, the foremost concern was with the rate of interests imposed on the loans. The new RBI Master Circular on micro-credit states that the interest rate applicable to loans given by banks to micro-credit organisations or by the micro-credit organisations to Self Help Groups/member beneficiaries would be left to their discretion.¹⁰⁹ It would be interesting to note that despite such guidelines, the RBI directions for NBFC-MFIs make no such stringent stipulations on interest rates. Such an inability to impose caps on interest rates is dumbfounding to say the least especially when there is a strong surge of commercialisation of MFIs. In addition to the creation of caps there also needs to be some structure *qua* interest rates. For example, interest rates charged by the MFIs are often not quoted in transparent annualised terms. Often, loans involve upfront fees

¹⁰⁷ *Id.*

¹⁰⁸ See Max Clarkson & Michael Deck, *Effective Governance for Microfinance Institutions*, (4th Annual Microfinance Network Conference, Establishing a Microfinance Industry, Niagara-on-the-Lake, Canada, November, 1996).

¹⁰⁹ RESERVE BANK OF INDIA, MASTER CIRCULAR ON MICRO CREDIT, RPCD. FID. BC.No. 53 / 12.01.001/ 2010-11, February 14, 2011.

and service charges, making calculation of effective interest rates complex and therefore non-transparent.¹¹⁰

B. IS A SINGLE REGULATOR THE ANSWER?

With the variety shown in the types of institutions and their regulation there has been a demand for an independent regulator for MFIs. Such a demand though, is not new. The Government of India introduced a draft Microfinance Bill in 2007 which lapsed due to delays in the Parliament.¹¹¹ Another amended version of the Bill was to be introduced in 2010 budget session however, after due deliberations the government has finally sought to table a new bill in 2011.¹¹² The query to be answered is that is having an independent regulatory body the correct solution? If so, then who should it be and what changes should be brought when they regulate?

The earlier bills put forth did take steps in the direction of having an independent regulator. Though, the inadequacies of the earlier Bills form a derisory basis for regulating the microfinance sector.¹¹³ The most notable feature was the designation of NABARD as the regulator. It seems that rather than setting up a regulatory body, the first institution at hand in relation to the MFIs was given the responsibility. The crucial point is that NABARD itself is a service provider.¹¹⁴ Making a service provider, the market regulator is contrary to good governance practices. There exists a potential conflict of interest.¹¹⁵ The provisions of the Bill concerning the regulator for the microfinance sector in India are inconsistent with the CGAP guidelines.¹¹⁶ The 2007 Bill designated NABARD as the single regulator for both depository and non-depository micro MFIs, while the guidelines suggest separate regulators for each. The guidelines, suggest that a central banking body such as the RBI should regulate depository MFIs. In this way such MFIs would be held at the same pedestal as banks and NBFCs.¹¹⁷

¹¹⁰ Mukul G. Asher & Savita Shankar, *Should NABARD be Micro Finance Regulator?*, September 2007, available at www.esocialsciences.com/data/.../Document1492007110.521023.doc (Last visited on March 12, 2012).

¹¹¹ Anto Antony, *Govt to enact only 2 bills in winter session*, September 19, 2009, available at http://articles.economicstimes.indiatimes.com/2009-09-19/news/28454033_1_banking-regulation-amendment-bill-microfinance-bill-bills-in-winter-session (Last visited on March 17, 2012).

¹¹² NDTV Profit, *Union Budget 2011: Pranab's reform push*, February 28, 2011, available at <http://profit.ndtv.com/budget/show-news/union-budget-2011-pranab-s-reform-push-142912> (Last visited on March 14, 2012).

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ Paul Hirst, *Democracy and Governance*, Chapter 2 in JON PIERRE, *DEBATING GOVERNANCE*, 2000.

¹¹⁶ Consultative Group to Assist the Poor, *Good Practice Guidelines for Funders of Microfinance: Microfinance Consensus Guidelines*, available at <http://www.cgap.org/gm/document-1.9.2746/donorguidelines.pdf>, (Last visited on March 16, 2012).

¹¹⁷ *Id.*

Further, there existed a pedantic challenge to the government's position on regulation. None of the earlier bills define specific criteria of what kinds of institutions are they catering to. The 2007 Bill defined a micro finance organization as "including societies, trusts and cooperatives, leading to varying interpretations. The term "including" by means of standard statutory interpretation is used to introduce an exhaustive list.¹¹⁸ On a restrictive reading it is implied that NBFCs and § 25 companies are excluded from its scope. Thus, a shift has been expected defining microfinance as a financial service and not just money-lending.¹¹⁹

Addressing this limitation has become all the more important since larger and more commercially oriented entities such as sovereign wealth funds, private equity and hedge funds, which together form the "shadow banking" sector, which largely escapes national and international regulations, have begun to target the microfinance sector as potentially high-profit asset class.¹²⁰ The large commercial banks are also increasingly entering this sector with the same objective.¹²¹ The systemic risk that the microfinance sector could potentially pose has therefore increased, and correspondingly so has the need to regulate this sector.

With the dominant focus on primarily on lending, savings schemes have been overlooked. Regulation is needed to address the need for access to savings instruments and affordable remittance and payment services including those involved in various government schemes for low income groups.¹²² Though, a knee-jerk reaction must be averted in such a regulation. The 2007 bill permitted deposit collection by some types of MFIs without placing adequate safeguards.¹²³ Such limitation would be curtailed to a large extent by equating NBFCs with the same regulatory mechanism as normal banks.

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. It is proposed that the non-prudential regulation of all MFIs may

¹¹⁸ In this case, there is a strong common characteristic between all the institutions dealing in lending. So in this case, it is important to interpret it literally, restrictively. For a similar analogy, see *Godfrey Phillips India Ltd. v. State of U.P.*, (2005) 2 SCC 515.

¹¹⁹ Dinesh Unnikrishnan, *New draft of MFI Bill to give more teeth to RBI*, available at <http://www.livemint.com/2011/03/25002958/New-draft-of-MFI-Bill-to-give.html> (Last visited on March 18, 2012).

¹²⁰ Asher & Shankar, *supra* note 110.

¹²¹ The World Bank, *The World Bank/Brookings Conference on Access to Finance*, May 30-31, 2006, available at <http://www.info.worldbank.org/etools/library/latestversion.asp?230426> (Last visited on May 14, 2012).

¹²² Asher & Shankar, *supra* note 5.

¹²³ *Id.*

be carried out by an oversight board ('OB'), which should report to the RBI. The board should be broad-based in nature, consisting of representatives from government, banks, MFIs, SHG federations, Sa-dhan (the association of community development finance institutions) and NGOs (non-government organisations). The size of the board should, however, be manageable for effective oversight and functioning.

The above suggested framework involves having two regulators for the sector. While RBI would be the regulator for MFI banks permitted to offer savings and mobile based remittance services, the OB will set benchmarks for the industry to safeguard consumer interests. This framework addresses the systemic risk and the need for good governance and orderly development. It will also ensure that there is no conflict of interest between a service provider and a regulator. Consistent with the CGAP guidelines, in addition to effectiveness and cost of supervision, the socio-economic and regulatory context of India must be considered in deciding on the regulator for the micro-finance sector.¹²⁴ Before considering the choice of regulator in the Indian context, clarity is needed about whether the Bill attempts to regulate the microfinance sector as a whole, or whether it seeks to enable particular institutional forms of MFIs to offer savings services under the supervision of the regulator.¹²⁵

IV. EVALUATION OF THE NEW BILL

In light of the parameters set out in the preceding section, we now assess the forthcoming measures that the Government seeks to introduce to regulate the sector. The Micro Finance Institutions (Development and Regulation) Bill, 2011 was introduced by the government in June, 2011 to regulate MFIs under one comprehensive regulatory framework. The proposed legislation is an independent regulatory mechanism. The question though, is whether this can be any different from the existing structure in place.

The foremost aspect under purview would be the registration process. The Bill makes it mandatory that all microfinance institutions must obtain a certificate of registration from the RBI, including NBFCs, before they commence providing services.¹²⁶ Such NBFCs must comply with both the terms and conditions of registration and other directions issued by the RBI under the Reserve Bank of India Act, 1934 and those issued by the RBI under the Bill.¹²⁷ As a pre-condition to registration, a MFI must have a minimum capital requirement of INR 5 lakh, as opposed to the Malegam Committee recommendation of Rs. 5 crore.¹²⁸ We stated above that the standard for most prudential regula-

¹²⁴ Asher & Skankar, *supra* note 110.

¹²⁵ Hartaska, *supra* note 84, 5.

¹²⁶ See The Micro Finance Institutions (Development and Regulation) Bill, 2011 ('MFI Bill'), §10.

¹²⁷ *See id.*, §11.

¹²⁸ *Id.*, §12(1)(c).

tion norms have set the minimum capital requirement at Rs. 10 crore which has been reduced to a paltry sum under the bill which should be a cause of concern.

The fundamental difference between the NBFCs and the NBFC-MFIs is only about the client base.¹²⁹ MFIs serve the poor and the vulnerable and regulation assumes greater significance because of a disproportionate balance of power between the lender and the borrower. If this is recognised then the issue is about client protection more than anything else.¹³⁰ The Bill grants considerable powers to the RBI to regulate the operation of MFIs. The RBI may issue a cease-and-desist order to an MFI that conducts its business “in a manner prejudicial to the interest of its clients or depositors or the micro finance institution itself”.¹³¹ An institution’s certificate may be revoked if it does not comply with such order or the requirement of minimum assets, or any other direction issued by the RBI under the Bill.¹³²

One of the initial contentions put forth in this paper was that the MFI sector regulation needs to gradually shift towards prudential norms. Though, somehow the Bill has vide its provisions rendered the functioning of these norms toothless. The RBI under the proposed bill also has the power to require that an MFI create a reserve fund of such ratio as it may specify, and such reserve may be used only for purposes authorised by the RBI.¹³³ It has sweeping powers relating to audit of such institutions,¹³⁴ and even with regard to setting the business policy of any MFI – including controlling the number of individuals it may serve, the amount it may lend, and the interest rate.¹³⁵ In a way it can be stated that the Bill vests within the RBI specific powers to ensure monitoring of operational risks involved.

The Bill makes provisions for the delegation of powers to NABARD from the RBI while maintaining RBI’s superiority over matters dealing with MFIs.¹³⁶ This is in sharp distinction to the model proposed by us which divides depository and non-depository regulators keeping their jurisdiction in clear demarcation. There is, however, no such distinction in the present model proposed by the new Bill. Though, on an optimistic analysis this may not be all that bad but such a model does allow for key challenges to the proposed scheme from a lot of corners.

¹²⁹ M.S. Sriram, *Should we pick the Microfinance Bill?*, July 15, 2011, available at http://articles.economictimes.indiatimes.com/2011-07-15/news/29777994_1_microfinance-sector-microfinance-bill-draft-microfinance (Last visited on March 12, 2012).

¹³⁰ *Id.*

¹³¹ *Id.*, §13(1).

¹³² *Id.*, §14.

¹³³ *Id.*, §17.

¹³⁴ *Id.*, §§ 21-23.

¹³⁵ *Id.*, §24.

¹³⁶ *Id.* §38.

Interestingly, the Bill also provides for a mechanism by which ‘systematically importance MFIs’¹³⁷ are required to convert its institution into a § 25 company, after which it is liable to follow the directions of the RBI in relations to such institutions.¹³⁸ In relation to the clients of an MFI, the Bill creates a mechanism by which disputes between clients and MFIs may be resolved by “Microfinance Ombudsmen”.¹³⁹ This may be termed as a mechanism to curtail the profit seeking behaviour exhibited by most MFIs. One of the biggest challenges to this provision would, however, be that of a colourable legislation. The Bill thus, circumvents different state measures where legislations do not permit the unfettered use of residual claims. Furthermore, state control over organisations registered under a state law would cease in favour of a single central regulator, thereby, creating a huge jurisdictional challenge.

V. CONCLUSION

The farmer suicides in Andhra Pradesh in 2010 garnered excessive attention through print and electronic media for months on end owing allegedly to exorbitant interest rates being charged by private MFIs. Such dire situations are seen as a consequence of private MFIs turning to the market for capital. Criticisms to such a move include that since these institutions have gone public, there would be a demand for returns from the shareholders’ money. In such a scenario the end user of the financial aid from the MFIs (largely rural farmers) would bear the brunt of such a demand. It seems *prima facie* that such criticism held certain merit a large number of farmers who committed suicide blamed, usurious interest rates and coercive means of loan recovery as the reasons for them taking such a step. The state of Andhra Pradesh owing to large scale media and political pressure cracked down with firstly, issuing an ordinance and later replicating it into legislation. This law criminalized coercive loan recovery methods. In the immediate aftermath of the passing of the ordinance in October 2010, the state saw large scale arrests of MFI employees. The focus of the ordinance and later the Act has purely been on the lending and recovery mechanisms. The initial hypothesis put forth by us is that commercialisation of MFIs needs to be deterred. The basis of this proposition is that by commercialisation has led to excessive social costs, i.e. externalities on the society which it seems have not been considered by the MFIs. Such, social costs include, farmer suicides, coercive methods that have been used for loan recovery and reliance by farmers on informal means (notably unregulated money lenders).

Assuming that the influx of capital from the markets is beneficial in the long run for the consumer is plausible, independent regulators must be

¹³⁷ *Id.*, §2(o): Systemically important micro finance institution means a micro finance deploying such amount of funds for providing micro credit to such minimum number of clients as may be specified by the Reserve Bank by regulations framed under this Act.

¹³⁸ *Id.*, §15.

¹³⁹ *Id.*, §31.

brought into place in such a scenario. Through this paper we propose that regulation should be split on the basis of governance and transactions between the RBI and an independent board comprising of industry representatives and the government. The reasons are based upon grounds of transparency, uniformity and efficiency. While dealing with an argument against commercialization of MFIs we have looked at the role of profit in the sector. Profit plays a key role in the type of registration that companies undergo. Most of the companies that intend to make a profit register as NBFCs. Since the RBI itself states that it has registered close to eighty percent of these companies, it seems that there is no mandate to ensure registration. Being an institution that lends out loans to the poor at high interest rates, registration is an important facet that cannot be ignored. The absence of mandatory registration is one of the aspects that have to be considered.

The panic generated in the media and the subsequent action of the respective state governments and the banking agencies seems to indicate an urgent damage control. Commercialising the sector has been advocated by the developed countries. Though, it requires regulation. Somehow, Indian policy-makers despite realising the potential of the sector seem reluctant to regulate it through uniform regulators. Such a regulator would ensure a specific approach to regulate the sector which establishes corporate governance structure and avoids confusion that institutions so often end up being in. We propose that there should be a division in the regulatory mechanism on the basis of transactions and on the basis of ensuring internal governance mechanisms. Such a dual bodied setup would ensure a sense of semblance of uniformity for the MFIs to look up to. Though, the improvement of any structure would be based on the initiative taken by the government.

The step taken by the government vide the Microfinance Institutions (Development and Regulation) Bill, 2011 has in some ways answered the challenges brought about by the Andhra crisis. It has, however, simply vested all the regulatory powers within the RBI. Such a move vitiates the need for a separate bill as the functions of MFIs transcend banking and other options. Furthermore, in an attempt to make the definition of microfinance extremely broad the bill has included every possible institution that could have been brought under the ambit of regulation. While it seems to be exhaustive however, the threat of being regulated by a completely banking centric regulator would raise concerns within the industry. Unlike a dual model proposed the model proposed by the government has created a tiered structure which is optional at the discretion of the RBI thereby creating a power imbalance. Among other things, the bill at best seems to be a knee-jerk reaction to a crisis rather than a thought out process and needs to be streamlined further.

