

**Discussion Proceedings from
Roundtable on “Microfinance Bill: Need for a fresh outlook”
Organised under the aegis of Poorest States Inclusive Growth (PSIG) Programme
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Introduction

Regulation for microfinance in India has been a long standing priority and despite several efforts over in the last twenty years, the MFI sector does not have a comprehensive regulation covering all forms of MFI model. In the current context, the RBI regulations for NBFC-MFIs provide a framework for one particular legal form, and the financial inclusion policy discourse is dominated by the bank led PM Jan Dhan Yojana, Business Correspondent Model and setting up of new differentiated banking structures (Small and Payments Banks). MFIs operating as Societies, Trusts and Section-25 companies continue to be governed by separate laws under a paradigm correlating regulation with legal form rather than nature of business. In addition, the announcement for establishment of the Micro Units Development and Refinance Agency (MUDRA), the purview of regulation, registration and refinancing of MFI, becomes a significant step in accordance with the growth witnessed in the microfinance industry and a huge need to service low income groups.

A policy paper “The Microfinance Bill: Need for a Fresh Outlook” authored by Dr. Alok Misra was released for comments by ACCESS ASSIST and UNDP in the recently concluded Inclusive Finance India Summit on December 2014. The policy paper has analysed past attempts at regulation, the present situation of regulations specifically the RBI regulations and the Microfinance institutions (Development and Regulation) Bill 2012 and the report of the standing committee on finance, and suggests a road map for future for maximising the contribution of the MFI sector to financial inclusion.

ACCESS ASSIST, under the aegis of Poorest States Inclusive Growth (PSIG) Programme of SIDBI and DFID, organized a Roundtable in association with MFIN on February 24, 2014, to deliberate on the consensus on the outlook for microfinance regulation. Considering the MF bill of 2012, Standing committee recommendations and policy paper as a background, the roundtable aimed at receiving inputs from various stakeholders to finalize the policy paper with final recommendations for further advocacy. The discussions conducted during the roundtable forms a robust input in the MFI regulation, especially the NGO-MFIs.

Proceedings

Microfinance sector has emerged from the 2010 AP crisis as witnessed by enhanced growth, which is largely due to the regulatory framework put in place by the RBI leading to stability in the sector. However, the focus of regulation has been on the NBFC-MFIs, while NGO MFIs have been left to function under state laws. Taking the cue from pro-NBFC regulatory stance, the funders have also shied away from NGO-MFIs, shrinking the NGO-MFIs share in microfinance. The market for microfinance is big and under-served; and the regulatory stance needs to harness the available channels without any channel bias in furthering financial inclusion. Past legacy has shown that most of the present day NBFCs started as a NGO with development focus by serving the underserved, however majority transformed to NBFC-MFIs while some remain to work as NGO-MFIs.

It is an established fact, that formal sector banks cannot serve all and find it difficult to retail low ticket loans profitably. In addition all available channels including NGO-MFIs need to be nurtured, for they

possess the local touch and development focus. However, considering the fact that incorporation as society or trust may not be the ideal legal form for undertaking financial intermediation, there is some merit in regulatory comfort with NBFCs. Lenders especially equity investors also feel more comfortable with the legal form of NBFCs over NGO-MFIs. The ideal policy prescription to reconcile the gap between these two positions should be to provide a clear roadmap for NGO-MFIs to transform as NBFCs and in the interregnum also bring them under a unified regulatory framework built on principle of nature of business rather than legal form.

The Microfinance Bill of 2012, building on the past attempts at regulation tried to bring an omnibus framework for all forms of MFIs. However, the bill was not favoured by the standing committee on finance and as such the sector is back to where it was. In this context, it is imperative to debate whether a new bill is needed at this juncture when the share of NGO-MFIs has dwindled to below 10% and the sector is seeing a push towards formalization.

Need for regulation

The panel at the roundtable comprised of a mix of players, including representation from MFIN, M-CRIL, NBFC-MFIs, NGO-MFIs, investors, IBA, and sector experts. The members debated on the need for MFI Bill considering the changed policy landscape, the time and effort required for another round of legislative procedures and the suitable agency to champion the fresh impetus for a new bill, the majority, including the NBFC-MFIs supported the need for regulation covering all forms of microfinance, through the means of a bill.

The panel recommended that there is a need for prudential regulations to prevent systemic risks and allow institutions to grow. Appropriately, regulation should cover all forms of institutions. While there exists a clear differentiation between large and small players, a tiered regulatory structure balancing risks with pragmatism is more suited for the MFI ecosystem.

It was debated whether the call for a new bill covering all forms of MFIs is to protect institutions or customers? The group felt that in a way it is both as clients of such institutions are not able to readily move to another source of financial services, while the NGO-MFIs should also be given a chance through facilitating policy framework to transform to a more suitable legal form for financial intermediation. At present, it is difficult for NGO-MFIs to convert as NBFCs. Post this graduation window, if some continue to retain their NGO status, it has to be seen as their choice.

Key takeaways:

Client protection

It is a recognized fact that client protection is now strongly streamlined in the sector. The issue of client protection came into focus during the AP crisis and post that measures like Unified Code of Conduct, Responsible Finance initiative of SIDBI and global Client Protection Principles (CPP) have tried to bring clients to the core of operations. While client protection has gained prominence under the MFI model, the group felt that customers of SHG-Bank Linkage programme as well those served directly by banks or through Banking Correspondents (BCs) also need to be brought under the client protection framework.

The panel also highlighted that

- It is very difficult to determine productive usage of small loans. Since MFIs are catering to a set of customers where it is difficult to demarcate a clear boundary between productive and

consumption usage, the regulation should consider flexibility in this. For example, expenses on education, sanitation or health are at present being treated as non productive use.

Political framework

While the regulatory risk in the sector has been taken care of by the RBI, political risk continues to remain as witnessed by the sporadic incidents in various states. Such incidents expose the vulnerability of the sector and affects NBFC-MFIs too. In addition, often the state officials fail to differentiate between the likes of ponzi schemes, chit funds and the MFI with adverse consequences to the sector. The regulation covering all forms of MFIs can address this issue also by according a distinct space for regulated microfinance.

A few key questions that need to be addressed are;

- What should be the graduation/transformation mechanism for NGO-MFIs?
- What could be the sources of capital infusion/investments in NGO-MFIs?
- What could be the broad contours of the regulation and the content/guidelines for the new bill?
- Who should take the lead in pursuing the new bill?
- How to address the issue of interference by State Governments in functioning of regulated MFIs?

Conclusion

Given the fact that most NBFC-MFIs have evolved from NGO-MFI structure and the role played by remaining NGO-MFIs in furthering financial inclusion, it is evident that an omnibus regulation covering all forms of MFIs is required. At present, the NGO-MFIs to secure funds have to meet the same set of rules as stipulated for NBFC-MFIs, this leads to a paradoxical situation. As such, the regulatory approach should not be restricted to the legal type, but by the type of underlying activity / business. However, as it is clear from the current policy landscape, NGO-MFIs are not the ideal legal entities to undertake financial intermediation, there has to be a supportive framework to enable them to transform within a defined time frame.

It is equally important to have robust client protection principles for other players like SBLP and Banks catering to the same client segment and clear policy/legal protection against state government intervention.

Appropriately, the second phase to this approach will be to outline the details of the new MFI Bill, which can act as a policy informing and influencing document in the sector.