POLICY RESPONSE

August 2011

Response to the Draft Micro Finance Institutions (Regulations and Development) Bill 2011[1]

1. The Draft Micro Finance Institutions (Regulations and Development) Bill 2011 (the Bill) seeks to cover all entities engaged in 'microfinance activities' under a single regulator (the Reserve Bank of India) and prescribes various rules for such institutions.

2. It may be noted that under the current regulatory architecture, RBI governs both Banks and Non-Bank Finance Companies (NBFC). Specifically in microfinance, legal forms outside these two such as Trusts, Societies, Self-Help Groups and Section 25 Companies have been permitted to offer loans upto Rs. 50,000 as per the RBI Master Circular on Micro-Credit[2].

3. It may be pertinent to observe here that approximately 80% (by value) of the microfinance sector is accounted for by NBFCs. Therefore, 80% of the sector is already regulated in a manner that is consistent across over 10,000 NBFCs operating in India in various segments.

4. Two concerns have emerged in recent times vis-a-vis microfinance. a) the regulatory jurisdiction of RBI vis-a-vis Micro Finance Institutions (NBFCs and other legal forms) has been challenged by the Andhra Pradesh State Government b) Concerns have been raised regarding the nature of consumer protection arrangements for low-income households dealing with MFIs.

5. The Bill clarifies that the regulatory jurisdiction over all entities engaged in providing microfinance shall reside with the RBI and rules out state government involvement in the same except through advisory councils. This clarification is crucial and timely.

6. However in the pursuit of clarity, the Bill ends up creating a new set of rules and guidelines that are inconsistent with existing prudential regulation for NBFCs. This includes rules relating to deposit- taking, capital requirements and benchmarks for systemic importance. An NBFC engaged in microfinance therefore faces a fundamentally different regulatory landscape than say, an NBFC engaged in asset-backed financing. This might inadvertently create significant regulatory arbitrage. This is particularly relevant since the definition of microfinance is very broad and cannot be easily ascertained.

7. The Bill envisages that even very thinly capitalised MFIs (with a capital base of as low as Rs. 5 lakhs) can raise deposits from their members. Deposit taking by thinly capitalised entities will create massive systemic risk and will jeopardise financial stability. Any external shock affecting the credit quality of the asset book of such an entity will coincide with the withdrawal of savings by its depositors, thus making the institution inherently unstable. Regulation has hitherto not permitted NBFCs to even be Business

[1] http://foundation.ifmr.co.in/Files/Draft%20MFI%20Bill_04072011.pdf
[2] DNBS.PD. CC.No. 120 /03. 02.004 / 2008-09

Correspondents of Banks let alone engage in deposit taking directly. There is no question that savings is an important service for clients of MFIs. However, collection of thrift must be allowed only on behalf of well-capitalised financial institutions that have the expertise to deal with the associated risks and asset-liability mismatches.

8. The enforcement of rules laid out in the Bill places tremendous demands on the RBI in terms of its own capacity to carry out detailed monitoring of even those entities that pose low systemic risk. There is no onus placed on market-based supervision, through commercial banks or rating agencies. Given the regional spread and diversity of MFIs, the micro-supervision envisaged in the Bill may be very challenging in reality. Regulatory resources are indeed scarce and may be put to use to design the boundaries within which various market players can compete and innovation be fostered without compromising the interests of the customers and stability of the system.

9. The Bill is silent on issues of customer protection that were ostensibly at the heart of the Andhra Pradesh Governments motivation to regulate MFI activity in the state. There is absence of a strong consumer protection framework for financial services in general in India, which various regulatory bodies are starting to look into.

10. There is an unprecedented opportunity for this Bill to proactively lay out a framework for consumer protection vis-a-vis financial services provision to low-income households, whether it is undertaken by banks, non-banks or other organisational forms. This would include norms on product information disclosure and recovery practices while also laying out a framework for enforcement of the same. Such a Bill would truly complement existing regulatory frameworks while addressing some of the root causes of the recent crisis. If over and above this, there is a need to strengthen micro-prudential regulation for non-bank finance companies; that may be best done directly under Chapter III-B of the Banking Regulation Act (1934) to ensure consistency rather than through a separate Bill.