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FINISH LINE IN SIGHT BUT HURDLES REMAIN: A PERSPECTIVE ON THE DRAFT MICRO FINANCE INSTITUTIONS (DEVELOPMENT AND REGULATION) BILL 2011

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The Ministry of Finance of the Government of India unveiled draft legislation earlier this month, aimed at bringing the microfinance industry within a central regulatory framework, and has opened it up for comment and feedback from various stakeholders.

The draft 'Micro Finance Institutions (Development and Regulation) Bill 2011' comes nearly nine months after the Andhra Pradesh State Government passed an ordinance – later passed into state law – that imposed stringent restrictions on microfinance firms, particularly in terms of recovery and interest rates, and practically froze bank lending to the sector.

The size of the microfinance industry in India is estimated to be about Rs24,000 crore, of which Andhra Pradesh alone is estimated to account for almost a quarter, or Rs7,400 crore.

The AP law practically paralysed the microfinance industry, forcing some of the largest MFIs to enter corporate debt restructuring programs. The effect on smaller firms has been even more catastrophic.

Even now, the AP government is defending a court case filed in the state High Court against its MFI Act.

The draft Bill, though late in coming, is welcome, and will help resolve long-festering uncertainties about interest rates, margins, and an appropriate regulatory structure for the industry, while freeing up MFIs from the purview of differing state-level moneylending statutes.

However, the industry might have to wait a while before it can breathe entirely easy – the monsoon session of Parliament is due to run August 1 through September 8, and it is anybody's guess if the Bill will be taken up in this session, or indeed if it will pass.

In this note, we offer the following comments on the draft Bill, under separate sub-headings for Positive Features, and What Could Have Been Better.

POSITIVE FEATURES

Among the clear positive features of the draft legislation are the following:

Providing legitimacy to the sector

As we have previously stated, the most fundamental positive impact of the introduction of this Bill is that, if adopted, it will provide sorely-needed legitimacy to the microfinance sector, and remove the regulatory uncertainty that has so severely damaged the sector since the Andhra Pradesh (AP) Ordinance was issued in October 2010. This alone would explain why the market and practitioners have responded so positively to this draft Bill – as they probably would have, to almost any draft perceived as not completely unreasonable.

Confirming the RBI as the single regulator

The Reserve Bank of India (RBI) is clearly positioned as the single regulator for the microfinance sector (although there is scope to "sub-contract" to other institutions), covering all types of microfinance institutions (MFIs), including not-for-profit as well as for-profit institutions, irrespective of their legal form. The establishment of a single regulator for the sector is important, to help prevent regulatory arbitrage through different legal structures.

Eliminating state-wise supervision

The current draft of the Bill removes the confusion over federal and state jurisdiction, which contributed to the AP crisis. A central Microfinance Development Council, along with State Advisory Councils, will act as a mechanism to elicit involvement of a range of stakeholders, including state governments. The sector is thereby freed from direct supervision by state governments. The role of state governments is defined and largely confined to the State Advisory Councils, which provide mechanisms for the representation of state interests and addressing state concerns.

The current draft clearly states that MFIs do not come under the purview of the Money Lenders' Act (although, as we are aware, the AP State Government has announced its intention to contest the constitutional validity of this assertion).

Including services beyond credit

The current draft includes thrift services, insurance, and pension products as among services that might be permitted to be offered by MFIs at a later time, but within prescribed guidelines. It remains to be seen to what extent the RBI will allow MFIs to offer thrift products to their clients. The RBI has, for historic reasons, been very wary of allowing NBFCs to collect savings from the general public. Even if the government does permit MFIs to collect savings from its customers, it will almost certainly set very stringent conditions, particularly concerning capital adequacy and deployment of funds.

The current draft identifies the category of "systemically significant" entities; presumably to allow for a different approach on supervision and regulation.

Microfinance Development Fund

The current draft lays the ground for the creation of a Microfinance Development Fund, which hopefully will act as a channel for patient social capital.

Continuation of PSL status

A final positive feature of the current RBI position (this is not actually set out in the draft Bill) is that loans to microfinance institutions will continue to be treated as Priority Sector Lending. In its policy announcement in May, the RBI had stated that bank loans to MFIs, and NBFCs working as MFIs, would be considered PSL, dependent on certain conditions.

WHAT COULD HAVE BEEN BETTER

Among aspects of the draft legislation which we wish were different are the following:

Better Late Than Never?

First, and without apology, we believe that fundamentally, this regulation should have come earlier. The AP crisis was a genuine emergency, and should have been responded to as such. However, it is now done, and is unquestionably welcome.

Too prescriptive

The current draft is heavily prescriptive – on registration, customer segments, margins, tenors, quantum of loan, fees, location of sanction / disbursement, and other matters. There is now, effectively, very little space for innovation in product design (except in the 15% of assets which need not count towards qualifying for treatment as a MFI). The RBI's usual approach, of creating a policy framework and allowing industry participants to design their own products and processes within the policy framework, would normally be considered lighter, and a more effective regulatory approach.

Corporate events need RBI Approval

Many corporate steps, including registration, raising capital, ownership changes, amalgamation, and closure or winding up, will need RBI approval. Previously, these were required to be *notified* to the RBI, but did not generally require RBI 'approval'.

Minimum NOF

The minimum Net Owned Fund required for any MFI to register is set, in the current draft, at INR 5 lakhs (INR 500,000). This amount is unrealistically low and the RBI's guidelines, once released, are likely to be different for different legal forms. For NBFC MFIs, we understand the minimum NOF figure is likely to be increased to at least INR 5 crore (INR 50 million). In any case it would not be feasible today to start a MFI with INR 5 lakhs NOF, given the pricing restrictions and capital adequacy requirements.

Overly-stringent reporting and monitoring requirements

The draft has made detailed prescriptions on monitoring and report filing, complying with which will clearly need time, energy and resources, all in the context of a prescribed rate regime. These changes may, in practice, impose some genuine implementation and reporting difficulties upon industry participants, and even on the RBI's supervisory bandwidth, at least in the first year or two of implementation.

The number of institutions that the RBI has to supervise and monitor will rise significantly, as they will now need to accommodate the large number of smaller not-for-profit MFIs. The RBI may have to adopt different supervision norms for MFIs that are systemically important and for those that are not.

Along the same lines, we question the practicality of monitoring the prescribed interest rate margin, in an environment where interest rates might change (as they have done frequently in India, in the past year). In case of a change in the interest rate of an MFI's debt, it is not clear how immediately MFIs would be expected to adjust rates charged to their own borrowers, and to what extent the RBI would be able to re-calibrate its monitoring parameters accordingly.

Obligation to create Reserve Fund

The current draft mandates the creation of a reserve fund by all entities in the business, before any dividend is declared or surplus utilized. Although the amount or percentage of reserve has not yet been specified, this requirement adds to the burden of doing business. In an environment where the final price of loans is prescribed, and given the rising costs of funds, operations, credit bureau participation and compliance, this requirement adds an additional encumbrance, to what appears to be well on the way to becoming a heavily regulation-burdened business.

Maximum Qualifying Income

From the Malegam Committee recommendations onwards, successive draft regulations have prescribed a maximum income limit (or as now, two separate maxima, one each for rural and urban environments), for borrowers to qualify for microfinance lending. We are fundamentally opposed to the declaration of a maximum qualifying income, for the following reasons:

- it is difficult to monitor, especially in the largely informal economic environment in which most micro-borrowers work; and
- more importantly, because it effectively incentivizes the concealment of income.

In our White Papers, we had suggested restricting loan amounts to a variable maximum, which would be based on borrower income. This small change would encourage the reporting of income more accurately, and dis-incentivize the concealment of income. We continue to believe it should be the preferred approach.

In addition, like any absolute rupee amount, this figure will need to be revisited and probably adjusted from time to time.

Continued adherence to the margin cap principle

The proposal in this draft, originally in the Malegam Committee's recommendations, to cap interest rate margins leads, as we pointed out in our White Paper, to some skewed results. The reason is that if the cost of an MFI's debt decreases, the impact of the reduced cost of funds is only effective over the proportion of the MFI's portfolio which is funded by debt, and not over the proportion which is funded by equity. On the income side, however, the margin cap applies to the entire portfolio. Hence reductions in borrowing costs actually have a negative impact on the bottomlines of MFIs when margins are capped. This could result, in some circumstances, in some counter-intuitive inducements, e.g. for MFIs to actually seek out higher-interest loans. We recommended earlier, and continue to recommend, that the margin cap be done away with. With an overall cap on interest rates, its utility in protecting borrower interests is, in any case, anyway questionable.

Specific relief for MFIs in Andhra Pradesh

An important real-world gap (though perhaps more appropriate for an RBI guideline than for a Bill) is that there is no specific relief proposed for MFIs operating in Andhra Pradesh, which have been severely damaged by the AP Ordinance. By the time this Bill becomes an Act (it is likely to be introduced in the winter session of Parliament), irreversible damage will have been done in AP. By October this year, AP clients' repayment defaults will approach the one-year mark. This level of default will be hard to recover from, particularly if state government officials continue to be hostile as some still are, unless some significant relief is provided.

We would continue to ask if it is possible to relax provisioning norms for the MFIs, or provide some interim relief for MFIs in AP, in recognition of the difficulties they are facing. Incremental microfinance disbursements outside of AP are now a function of the extent of lending by various banks to MFIs. Realistically, AP itself will probably take a very long time to recover from the current crisis, and for the confidence to return to resume normal microfinance activities.

A fundamental question, however, remains: Is it possible for the AP State Government to demonstrably and publicly state that existing repayment commitments must be honoured?

CONCLUSION

The draft Bill is a much-needed, and welcome, first step towards normalizing and stabilisng the microfinance industry. It fulfills some, if not all, of the key desires of stakeholders, particularly the MFIs. As the CEO of one firm put it, the draft Bill is “macro on regulation, micro on vision”.

While the bill in its current form is not long on detail, that will likely be addressed once the RBI releases its guidelines.

However, at least one major roadblock lies ahead: if the AP State Government wins its current court case seeking to regulate MFIs under the state’s Money Lenders Act, all above comments may be invalidated – and in that scenario, all bets are off.