Microfinance Institutions Bill: return of the prodigal son

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The recently issued draft Microfinance Institutions (Development and Regulation) Bill, 2011, offers a ray of hope for India's crisis stricken microfinance institutions (MFIs). Over the last couple of years, the industry has been in the headlines for all the wrong reasons: the very public boardroom squabbles of a premier MFI and suicides by poor farmers, allegedly as a result of harassment by loan recovery agents.

The state of Andhra Pradesh, which accounts for approximately 40% of India's MFIs, was the first to react to these tragedies. It promulgated an ordinance that laid down stringent norms on recovery of loans to be followed by MFIs. The fallout of this was bad debts of approximately ₹90 billion (US$2 billion) and with banks simultaneously putting the brakes on credit, many MFIs went bankrupt. The Microfinance Institutions Bill, therefore, comes at a time when the credibility of the industry is at a record low.

Legitimacy restored

At the very outset, the bill declares that MFIs will be treated as "extended arms of the banks and financial institutions" and that they will be considered as valued partners of the Reserve Bank of India (RBI) in its push for financial inclusion. This reaffirmation of the legitimacy of the microfinance sector gives greater clarity on its role in the upcoming years.

Turf wars – centre v states

The bill designates the RBI as the sole regulator of this industry, although it may choose to delegate its powers to the National Bank for Agriculture and Rural Development. The bill also envisages the creation of Development Finance Councils, which will help formulate measures to promote financial inclusion, at both central and state levels.

According to the bill registered MFIs would not be subject to state legislation governing money lending. This has led to a chorus of protests from several states, notably Andhra Pradesh, which recently enacted the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Act, 2010.

Notable features

To a large extent, the bill implements the recommendations of a committee – the Malegam Committee – set up by the RBI to study the sector. One of the many important changes it will result in is mandatory registration with the RBI for all MFIs with net owned funds greater than ₹500,000. This seeks to flush out all existing fly-by-night operators and ensure greater protection to the public.

Additionally, MFIs with assets valued at greater than ₹1 billion will need to be incorporated under the provisions of the Companies Act, 1956 – either as a section 25 company or as a non-banking financial company.

The bill proposes to also cap the maximum operating margin chargeable by a MFI, which includes all costs and fees payable by borrowers. This addresses a serious allegation routinely levelled against MFIs: they give loans at usurious rates to poor rural folk, earn huge profits and all under the pretense of being do-gooders.

For the first time, MFIs will be allowed to accept deposits from their customers in the form of "thrift collection". This limits the scope of the activity and keeps it distinct from acceptance of demand deposits by banks, but also substantially broadens the scope of MFIs.

To enhance transparency and client protection the bill includes prudential norms, mandatory audit of accounts, reporting requirements and grievance redressal mechanisms.

Bouquets and brickbats

The MFI industry has welcomed the bill and is palpably relieved that the draftsman has classified its activities as distinct from that of money lending. While many observers have reservations about the RBI being given the authority to micro manage the industry, markets have reacted positively. SKS Microfinance, the sole listed Indian MFI, saw its shares appreciate by 20% after the draft bill was released.

However, pointing out that the RBI, which regulates NBFCs, could not prevent the tragedy of farmer suicides, the government of Andhra Pradesh has demanded a greater role for state authorities in this matter.

Observers also argue that the real problem is the high interest rates charged by MFIs and merely regulating margins is not the solution. In addition, as the financial parameters involved are variable and extremely technical, there is scope for fudging figures to circumvent caps.

With MFIs set to be treated as extensions of banks, there are fears that banks may engage them to carry out their rural banking obligations. This would mean the MFIs would be the sole provider of financial services for India's villages.

It is hoped that this second chance at redemption is not squandered and MFIs regain their status as harbingers of socio-economic change.

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