CONSUMER PROTECTION AND FINANCIAL INCLUSION IN INDIA: AN ANALYSIS OF THE DRAFT 2011 MICROFINANCE BILL

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Abstract:

This paper argues that the implementation of the 2011 Draft Indian Micro Finance Institutions (Development and Regulation) Bill is fraught with challenges and complexities that are still to be borne out in the legislative process. Central to the ultimate success of the guidelines enshrined in the Bill will be the level of rigor exhibited by the Reserve Bank of India (RBI) with respect to interest rates, initial capital requirements and margin caps, and the ability of the RBI to safeguard consumers against usurious lending practices while also promoting growth, development and innovation in the microfinance sector. The paper reviews the Bill in relation to the goals of financial inclusion, consumer protection and the growth of microfinance in India and globally. It traces the origin of the current legislation by providing an historical overview of microfinance and microfinance regulation in India from both a supply and demand side. The Bill's main principles are analyzed in the context of international best practice guidelines for microfinance regulation. The analysis is rooted in "social cost" theory developed by R.H Coase, which postulates that the problem of regulation is often a reciprocal one, in that A is harmed, and B is also harmed, and therefore the objective should be to reduce the more serious harm. This paper argues for a balanced and risk based approach to microfinance regulation in which no one actor is overly harmed by the provisions of the regulation.

INTRODUCTION

The 2011 Draft Indian Micro Finance Institutions (Development and Regulation) Bill (MFIB) is a watershed moment for the microfinance sector in India. The MFIB[1] represents a national level regulatory response to the second microfinance crisis which took place in October 2011 in the Indian State of Andhra Pradesh. The MFIB provides comprehensive regulation and supervision of the MFI sector. However, the actual implementation of the guidelines enshrined in the bill are fraught with challenges and complexities that are still to be borne out. Central to the ultimate success of the legislation will be the level of rigor exhibited by the Reserve Bank of India (RBI) with respect to interest rates, initial capital requirements and margin caps, and the ability of the RBI to safeguard consumers against usurious lending practices. Will the 2011 MFI Bill be a regulatory regime that creates a constructive environment for financial inclusion or a regulatory regime that protects political interests and promotes anticompetitive practices? This paper provides a detailed assessment of the implications of the 2011 MFIB for the growth and development of the Indian MF sector.

The paper will trace the origin of the MFIB by providing historical context to the India's regulation of microfinance activities. It will then analyze the MFIB in relation to the goals of financial inclusion, consumer protection and the growth of the MFI sector within the context of international best practice guidelines. Appendix 1 provides an overview of the most relevant best practice guidelines. The analysis will be rooted in "social cost" theory developed by R.H Coase, which postulates that the problem of regulation is often a reciprocal one, in that A is harmed, and

[1] The paper will refer to the 2011 MFIB interchangeably as "The Bill," The "MFIB," and the "2011 MFI Bill." All Legislation is available at CGAP Regulation Center India. Accessed throughout the writing of this study. http://www.cgap.org/p/site/c/template.rc/1.26.13731/

B is also harmed, and therefore the objective should be to reduce the more serious harm.[2] This paper will argue for a balanced approach to regulation in which no one actor is overly harmed by the provisions of the regulation, protecting consumers at the same time as building a robust MFI sector in India. This paper takes the view that the 2011 MFIB will be challenging and costly to implement and could well further damage the sector if it is not done in a balanced manner, taking care to include the voices of government, the financial services industry, non-profits and clients themselves.

This paper is organized as follows: **Section I** provides a brief review of the theoretical underpinnings of microfinance regulation. **Section II** provides an historical overview of the development of the Indian MF sector, and the current financial regulatory structure. **Section III** sets forth a summary of the recent microfinance crisis in Andhra Pradesh and its implications for the MF sector in India. **Section IV** employs an assessment criteria model developed by Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) to discuss the most important aspects of the Bill[3]. **Sections V and VI** apply two international best practice frameworks to the MFIB to assess the correlation of the Bill with current thinking on legal principles for microfinance regulation and supervision. The two frameworks include the Basel Core Principles of Effective Banking Regulation and Consultative Group to Assist the Poor (CGAP) consumer protection principles. [4] The frameworks will be used as tools for a detailed assessment of the potential costs and benefits of the Bill for MFIs and their customers in India. **Section VII** concludes by suggesting a series of recommendations and identifying certain challenges for future MF regulation in India.

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[2] Coase, R.H. *The problem of social cost.* Journal of Law and Economics, Vol. 3, 1960. P. 2.

[3] See Eschborn, *Regulatory Requirements for Microfinance,* GIZ, 2003. Annex 2: Criteria for the Assessment of Legal Frameworks for Microfinance.

[4] See Bank for International Settlements. *Microfinance Activities and the Core Principles for Effective Banking Supervision,* Basel Committee on Banking Supervisions. 2010. And Peck, Robert Christen; Lauer, Kate; Lyman, Timothy and Richard Rosenberg *A guide to Regulation and Supervision of Microfinance*. CGAP 2011.

I. MFI REGULATION OVERVIEW

It is accepted that the regulation and supervision of financial institutions should attempt to minimize risks to the financial stability of the institutions that participate in the sector, and the financial system as a whole, in a cost effective manner.[5] Regulation of microfinance is increasingly viewed as a tool to increase access to financial services for the unbanked and poor by providing incentives to microfinance institutions (MFIs) to lend while protecting borrowers from predatory lending practices. Theses dual objectives, however, may not be mutually reinforcing. For MFIs, the poor represent a large market of borrowers who also pose considerable risk. Therefore, there is an incentive to provide more and more loans with higher interest rates to serve the market and manage risk. This can quickly create a situation of borrower over indebtedness and a high risk of borrower default. To combat these dangers, an effective regulatory regime must provide stability and predictability both for consumers and for MFIs. This section will provide an overview of microfinance regulation.

A. Regulation Theoretical Framework

The theoretical rationale for microfinance regulation, and for financial regulation in general, is predicated on the notion of social costs, as developed by R.H Coase. Coase clearly delineates how actors, both economic and social, are endowed with differentiated sets of rights and capacities to produce social costs. These variable levels of rights create a situation of power

[5] Peck, Robert Christen; Lauer, Kate; Lyman, Timothy and Richard Rosenberg *Microfinance Consensus Guidelines: A guide to Regulation and Supervision of Microfinance*. CGAP 2011. P. 10.

asymmetry among actors in any socioeconomic environment. The cost of exercising a right (of using a factor of production) is always the loss which is suffered elsewhere in consequence of the exercise of that right.[6] When constructing a new social arrangement, akin to the reorganization of the microfinance sector through the 2011 MFI bill, we have to bear in mind that a change in the existing system which will lead to an improvement in some respects may well lead to a worsening of others. [7] This framework of costs and benefits, created through a set of rules or *regulation,* to borrowers and lenders should be kept in mind when considering the regulation of microfinance in India.

B. Defining Microfinance and Financial Inclusion

According to CGAP 2011 consensus guidelines, *microfinance* can be defined as "the provision of formal financial services to low-income people, as well as others systematically excluded from the financial system, including a range of products to fund social obligations as well as savings, money transfers and insurance."[8] MFIs are defined as "institutions whose major business is the provision of microfinance services."[9] *Financial inclusion* refers to the "policy goal of reaching all financially excluded households with a full range of responsibly delivered, affordably priced, reasonably convenient financial services."[10]

C. Defining Regulation and Supervision of Microfinance

[6] Coase, R.H. 1960. P. 43.
[7] Ibid. P. 44.
[8] Peck, Robert Christen; et al. 2011. P. 10.
[9] Guha, Samapti. *Salient Features of the Microfinance Institutions in India.* IPRF Working Series . No. 01/04. P. 2.
[10] Peck, Robert Christen et al. 2011. P. 10.

Establishing a rational legal or regulatory framework to govern private microfinance activities is generally considered a better way to promote microfinance, and to increase the depth and breadth of financial services, than for governments to directly participate in market transactions.[11] With this in mind, and paired with the rapid growth of microfinance in the developing world, many countries have recently adopted specialized regulatory and supervisory frameworks for microfinance. CGAP defines *regulation* as the "binding rules governing the conduct of legal entities and individuals, whether they are adopted by a legislative body (laws) or an executive body (regulations)" and *supervision* as the "external oversight aimed at determining and enforcing compliance with regulation."[12] As microfinance has continued to grow, policymakers have realized that existing financial regulatory frameworks must be tailored and revised to take account of the unique characteristics of microfinance activities.[13]

D. Summary of Perceived Benefits and Costs of Microfinance Regulation:

While there is general consensus on the *need* for a constructive regulatory environment for microfinance, there is less -consensus with respect to how to create such an environment. There are generally two approaches advocated in the literature. The first focuses on the benefits of microfinance regulations and argues for a tiered-approach with a concentration on enabling MFIs to be transformed into deposit taking institutions. The second strand of the literature

[11] Ledgerwood, Joanna and White, Victoria. *Transforming Microfinance Institutions: Providing full financial services to the poor.* The World Bank and The Microfinance Network. Washington DC. 2006. P. 21

[12] Peck, Robert Christen; et al. 2011. P. 6.

[13] See Basel Guidelines for Effective Banking Regulation for a discussion of the unique characteristics of Microfinance. Examples of these characteristics include: Short term, unsecured and small loans, high credit risk , streamlined and lean licensing criteria, lower initial capital requirements, higher capital adequacy ratio (CAR) due to fewer options to raise capital, the need for risk management systems (credit rating bureaus), a strong focus on consumer protection (transparent pricing, reasonable interest rates and margins), and supervisory structure tailored for MFI.

focuses on the costs of regulation and warns of the difficulties of regulating the broad and diverse range of institutions involved in providing microfinance services.

During the past 10 years, best practice guidelines have been developed to provide recommendations for country regulators on how to construct a favorable regulatory framework for MFIs. By and large, these best practice guidelines advocate for a *risk based* rather than *ratio based* approach to MFI regulation. [14] Rather than primarily focusing on financial statement analysis (ratio based), regulators have been urged to create a dynamic regulatory framework that provides principles of internal governance and management, external supervision and sanctions when appropriate. It has been advocated that the regulatory regime should identify thresholds of financial intermediation activities so MFIs can progressively evolve into formal (deposit taking) financial institutions.[15]

Within the other, more cautionary literature, there is a focus on seriously considering the challenges facing a given country's supervisory agency, and the realistic obstacles to meeting those challenges when examining proposals for regulating microfinance. [16] Regulation and supervision entail significant costs, and it has been suggested that the regulatory agencies should view themselves more as enabling bodies than as managers of the entire MFI sector. Both of these strands of the literature will be infused into this paper in order to provide a balanced analysis of the Bill.

II. OVERVIEW OF THE INDIAN MICROFINANCE SECTOR

[14] *Ratio based* means based on financial ratios like return on equity, return on assets, return on investment and operational self-sufficiency while risk based means based on the riskiness of the loans outstanding on a bank's balance sheet and the management capacity of the MFI. A risk based approach would focus on indicators like loan-loss supervision, portfolio at risk and the credit rating of the bank, among other elements.

[15] Greuning, Hennie; Gallardo, Joselito, and Randhawa, Bikki *A framework for Microfinance Institutions*. Financial Sector Development Department, World Bank, 1998. P.i.

[16] Christien, Robert Peck, Rosenberg, Richard. *The Rush to Regulate: Legal Frameworks for Microfinance.* 2000. P. 4.

India provides probably the largest market for microfinance in the World. Microfinance in India started in the early 1980s with small efforts at forming informal self-help groups (SHG) to provide access to much-needed savings and credit services.[17] Microfinance has generally been defined as an activity that is undertaken by the alternative sector, either by NGOs or SHGs, predominately with the poor and for explicit/implicit economic and social development related objectives. Recent developments in microfinance in India are critical to an analysis of the genesis of the 2011 MFI Bill, and its implications for MFIs and microfinance consumers.

A. The Demand Side: Poverty, Population and the Un-Banked

The demand for microfinance is significant due to India's large population, high poverty rate and weak financial services penetration. India's population is estimated to be approximately 1.2 Billion. [18] India has experienced significant economic and social development over the last thirty years. India still has a large percentage of its population living below the national (27 percent)[19] and international poverty lines (35 percent).[20] Intellecap, a strategic consulting firm, estimates that the Indian population below the poverty line to which microfinance services can be marketed is between 57.9 million and 77.3 million people.[21] Using the same data, Intellecap estimates a potential, annual market of approximately $20 Billion USD for microfinance services

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[17] Siriam, M.S and Upadhyayula, Rajesh. *The Transformation of the Microfinance Sector in India: Experiences, Options and Future.* Journal of Microfinance, Volume 6, Number 2. 2009. P. 89.
[18] CIA world Factbook. Accessed November 23, 2011. https://www.cia.gov/library/publications/the-world-factbook/geos/in.html.
[19] World Bank Data. Accessed November 23, 2011. http://data.worldbank.org/country/india.
[20] Intellecap and IFC. *Inverting the pyramid: The Changing Face of Indian Microfinance.* 2007. P. 23. The international poverty line used in these statistics is the UNDP Human Poverty Index (http://hdr.undp.org/en/statistics/indices/hpi/). For further information on the SHGs, please see Reddy, CS and Manak, Sandeep. *Self Help Groups: A keystone of microfinance in India- Women Empowerment and Social Security.*2005. http://www.aptsource.in/admin/resources/1273818040_SHGs-keystone-paper.pdf
[21] Ibid. P. 23.

in India.[22] Financial services penetration in India is weak. Intellecap has identified that only 169 million people have bank accounts.[23]

B. The Supply Side: Microfinance Delivery Channels

Microfinance in India is primarily delivered through two main channels: SHG Bank Linkage (lending by banks to SHGs) and private and non-profit MFIs. Both the SHG approach and MFIs have been aided by the RBI's priority sector lending policy. This policy requires domestic banks to lend a significant portion of their net debt to underserved sectors.

In 1991, the National Bank of Agriculture and Rural Development (NABARD)[24] launched the SHG-Bank Linkage program, refinancing commercial bank loans to the SHGs in order to facilitate linkages between the banks and poor borrowers.[25] The linking of SHGs to the financial sector has been beneficial for both borrowers and banks. The banks tapped into a large market and repayment rates were high. From 2003-2007 total loans disbursed to SHGs increased from 353 million to 3.5 Billion USD. [26] Today, there are 4.5 million SHGs with 58 million members.[27]

By the early 1990s, economic reforms created the opportunity for NGO MFIs to transition to non-banking financial companies (NBFCs). Converting to an NBFC is popular because these entities can then avail themselves of cheap capital from the RBI and other sources. Such transformations have been observed worldwide, primarily because NGOs have been able to

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[22] Ibid. P. 24.
[23] Ibid. P. 25.
[24] NABARD was created in 1981 under Act No. 61 of 1981 for "providing credit for the promotion of agriculture, small-scale industries…with a view of promoting integrated rural development."
[25] Sa-Dhan Microfinance Resource Centre. *Association Existing legal and Regulatory Framework for Microfinance Institutions in India: Challenges and Implications*. 2006. P. 13.
[26] Intellecap and IFC. 2007. P. 33.
[27] CGAP. *Andhra Pradesh 2010: Global Implications of the Microfinance crisis in Indian Microfinance*. P. 1.

access the equity required for conversion to NBFCs.[28] By 2010, NBFCs were expanding at an annual rate of 80 percent, and had reached nearly 27 million borrowers across India, nearly all through use of the standard Grameen style joint-liability lending model, common to South Asia. [29] In 2010, the RBI reported 12,630 NBFCs registered across India, compared to less than 500 just 10 years prior.[30]

C. Recent Developments in Indian Microfinance

The most significant recent developments in Indian microfinance include the rise of the private NBFC MFIs vis-à-vis SHGs, the increase in clients taking on multiple loans (loan concentration rates), and the concentration of MFI loans in particular states, especially Andhra Pradesh. In only four years, NBFCs have increased their customer penetration from approximately 10 million to over 26 million customers. [31] NBFCs now account for more than four-fifths of all MFI loans and are dominated by five large MFIs.[32] This dramatic increase in the importance of NBFCs is exemplified by the recent initial public offering (IPO) by SKS, India's largest MFI. In stark contrast to the decentralized nature of the SHG model, 80% of microfinance loans in India are now concentrated in the top 16 MFIs.[33]

This exponential growth in microfinance has been experienced most dramatically by the Southern states of Andhra Pradesh, Tamil Nadu and Karnataka. For example, the residents of

[28] Shankar, Savita and Asher, Mukul. *Regulating India's Microfinance Sector: A Suggested Framework.* P. 2.
[29] Ibid P. 2
[30] RBI. *Report on Trend and Progress of Banking in India 2009-10.* New Delhi India. 2010. P. 144.
[31] Srinivasan, N. *Microfinance India. State of the Sector Report 2010.* 2010. P. 2.
[32] CGAP. *Indian Microfinance goes Public. The SKS Initial Public Offering,* 2010. P. 1
[33] EDA Rural Systems Ltd and M-Cril. *Of Interest Rates, Margin Caps and Poverty Lending: How the RBI Policy will affect access to microcredit for low income clients.* 2011. P. 1.

Andhra Pradesh make up approximately 20 percent of all outstanding loans in India.[34] Loan concentration is also a significant problem in Andhra Pradesh- with an average of 9.63 microfinance loan accounts for every household.[35]

D. Microfinance as a Priority Sector

Commercial banks in India are required to make a percentage of loans to priority sectors. Priority loans must account for 40% and 32% of net bank credit in the case of domestic and foreign banks, respectively.[36] In 2011, the RBI officially delineated important guidelines for MFIs to qualify for priority sector status, that complement the 2011 Bill.[37] These requirements are among the most restrictive regulatory requirements MFIs must now fulfill. First, the loan must not exceed Rs 60,000 to rural borrowers and Rs1, 20,000 to non-rural borrowers.[38] Second, total indebtedness of a borrower must not exceed Rs50, 000.[39] Third, the RBI established a margin cap of 12% for all MFIs.[40] Fourth, the interest cap for priority sector loans is capped at 26% per annum. [41] It is important to note the benefits and costs of priority sector designation: On the one hand, the designation provides a steady flow of capital from the commercial banking sector to MFIs, in accordance with the RBI's financial inclusion objectives. On the other hand, it ties these loans to prudential restrictions and places the RBI firmly in control of important performance indicators in the microfinance sector.

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[34] Shankar, Savita and Asher, Mukul. *Regulating India's Microfinance Sector: A Suggested Framework.* 2009. P. 6
[35] Ibid. P.4
[36] Ibid. P. 6.
[37] Although the term "MFI" is used here, this includes all organizations that provide microfinance services, including SHGs.
[38] RBI. *Bank Loans to Microfinance Institutions- Priority Sector Status.* RBI/2010-11/505. RPCD. CO.Plan BC. 66/04/09.01/2010-11. P. 1.
[39] Ibid. P. 2
[40] Ibid. P. 2
[41] Ibid. P. 2

E. Regulatory Actors

There are a wide variety of classifications, legal forms and overlapping structures involved in providing microfinance services in India. This proliferation of organizational entities and related regulatory requirements makes analysis difficult and the identification of the appropriate regulator unclear. Of the two main models of microfinance in the country, the SHGs are linked to commercial banks regulated by the RBI. SHGs themselves are regulated by NABARD.[42] In the MFI model, while NBFCs are regulated by the RBI, societies, trusts, not-for-profit companies (section 25) and cooperatives are technically regulated by state governments and the Registrar of Cooperative Societies (RCS). This complexity is one of the reasons the 2011 MFI Bill establishes the RBI as the sole regulator for all MFI services.

F. Defining Microfinance in India: Legal Forms

The majority of microfinance is provided by commercial banks, regional rural banks (RRBs), self-help groups (SHGs) (with special linkage programs to banks), cooperative societies, and microfinance institutions that take a variety of forms, including NGOs (registered as societies, trusts or Section 25 companies) and non-bank financial companies (NBFCs). Please see Appendix Two for a table outlining the various legal forms.

G. Legislation Pertaining to Supervision and Consumer Protection

[42] CGAP Regulation Center- India. Accessed November 25, 2011. http://www.cgap.org/p/site/c/template.rc/1.26.13731/

The Banking Regulation (BR) Act, 1949 provides the legal framework for formal banking in India. With the objective of integrating NBFCs with the financial mainstream, the RBI brought NBFCs under its regulatory arm by way of an amendment to the RBI Act, 1934 in 1996. This paved the way for mandatory registration of companies undertaking financial services with the RBI, compulsory credit rating of deposit taking NBFCs and the requirement that NBFCs comply with prudential norms. However, SHGs continued to be registered under NABARD, creating competition between SHGs and NBFCs for clients, and competition between NABARD and the RBI with respect to the complex task of supervision and regulation. The RBI has also issued a variety of acts related to consumer protection that form an important backdrop to the 2011 MFI Bill. See Appendix Three.

III. SUMMARY OF THE CRISIS IN ANDHRA PRADESH AND RECENT INDIAN MFI REGULATION

The 2011 MFI bill represents a national level response to the microfinance crisis that occurred in 2010 in the Indian State of Andhra Pradesh. Although microfinance penetration is not the same across all of India, Andhra Pradesh provides an important corollary for the sector as a whole. This section will outline the origins of the crisis, and the impact of the crisis on Indian microfinance, providing the background for the 2011 MFI Bill.

A. The Origins of the Indian Microfinance Crisis: Andhra Pradesh

This growth of SHGs and MFIs was especially noticeable in the Indian State of Andhra Pradesh. As mentioned above, the explosion of microfinance activities in Andhra Pradesh had resulted in an average of 9.63 loans per household in Andhra Pradesh by 2010.[43] In Andhra Pradesh, the average debt outstanding per household is Rs. 65,000 compared to a national average of Rs. 7,700 per household.[44] Five of the largest MFIs in India have also established headquarters in Andhra Pradesh. The high rate of clients with multiple loans, client indebtedness, and high level of MFI penetration in the state does not necessarily explain the situation in Andhra Pradesh. Rather, this situation was more brought on by supply side dynamics, namely, commercialization and completion among retail providers that put the focus on short-term over long-term growth and the infusion of inflexible products and services, supply-centric operations, inadequate loan appraisal processes and staff incentives among providers. [45]

These larger MFIs often have higher interest rates, shorter repayment periods and generally a less flexible approach to loan restructuring in the event of default. Government officials became worried that the profit making MFIs would gain market share in microcredit lending at the expense of the SHGs which previously had dominated the market. In 2005–2006 one of Andhra Pradesh's 23 administrative districts experienced a crisis when the district government closed 50 branches of four MFIs following allegations of unethical collections, illegal operating practices (such as taking savings), poor governance, high interest rates, and profiteering. [46] Dubbed the *first microfinance crisis*, the situation was largely calmed when the RBI stepped in, instituting a code of conduct for MFIs in 2007. This code of conduct, however, had little regulatory teeth and the intense competition continued.

The microfinance crisis continued to accelerate in 2010 amid the simultaneous SKS IPO

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[43] CGAP. Andhra Pradesh 2010. *Global Implications of the Microfinance crisis in Indian Microfinance.* 2010. P. 1. One reason why households in Andhra Pradesh have large amounts of credit under the SHG program is that in the late 1990s banks shifted from making loans based on a credit-savings ratio (usually Rs 100,000) to a more liberal policy that was based on arbitrary loan amounts (Rs500,000). Repayment periods were also extended to five years.
[44] Ibid. P. 3.
[45] CGAP. *Understanding Multiple Borrowing and Avoiding Over-indebtedness Among Clients.* 2012. http://www.cgap.org/p/site/c/template.rc/1.26.18502/
[46] Ibid. P. 2.

and reports of suicides linked to MFI practices. In reaction to these reports, the Andhra Pradesh government passed the *AP Ordinance* to protect women self-help groups from exploitation by the microfinance institutions and to control alleged abuses by such organizations. The Ordinance attributed the "suicides by many rural poor who have obtained loans from such individuals or entities (MFIs)" directly to MFIs that provided loans to members of SHGs. [47] The AP Ordinance provided the AP government with a variety of new powers including authority to cancel the registration of any MFI and strict penalties for contravening the registration rules, including imprisonment for up to 6 months. [48] The ordinance required MFIs to obtain written approval from the Andrah Pradesh government before lending to an SHG member who already had a loan outstanding[49], and stipulated that MFIs could not recover from a borrower an amount in excess of the loan principal upon default. [50]

In addition, before the AP Ordinance, MFIs were able to conduct weekly meetings with small groups of 40 women, which was critical to building and maintaining a strong credit culture and financial discipline.[51] MFIs were now allowed to collect loan payments only monthly as opposed to weekly, and the strong repayment culture rapidly eroded. [52] In the face of low loan collections, MFIs with proportionally larger exposures in Andhra Pradesh began to find it difficult to refinance their loans with commercial banks and to raise new equity.[53] The AP Ordinance was a cure that caused as much damage to the microfinance sector as the disease.

B. Post- AP Ordinance: The Impact on Indian Microfinance

[47] AP Ordinance. Statement of Objects and Reasons.
[48] AP Ordinance. Sections 3, 5.1 and 18.
[49] AP Ordinance. Section 10.1
[50] AP Ordinance. Section 9.1
[51] CGAP. Andhra Pradesh 2010. *Global Implications of the Microfinance crisis in Indian Microfinance.* 2010
[52] Legatum Ventures. *Microfinance in India: A Crisis at the Bottom of the Pyramid: How the Government of Andhra Pradesh has severely damaged private sector microfinance and put 450 million of India's rural poor at risk.* 2011. P. 6
[53] CGAP. *Andhra Pradesh 2010. Global Implications of the Microfinance crisis in Indian Microfinance.* 2010. P.1.

The AP crisis led to the reluctance of banks across the country to fund MFIs. M-CRIL, a credit rating agency, reported substantial reductions in the growth of microfinance lending with a 43% increase in borrowers in 2009-2010 declining to only a 7.5% increase in borrowers in 2010-2011.[54] The AP Ordinance derived its legal basis largely from state based India money lending laws initiated in 1918. The laws provide the government with the power to intervene in the face of "exorbent" interest rates. However, the authority to regulate at the state level created unpredictability for private MFIs that were subject to the whims of state government action.

C. The 2011 MFI Bill

The 2010-2011 Maelgem Committee was formed by the RBI in order to "study issues and concerns in the microfinance sector and delineate the objectives and scope of regulation of NBFCs undertaking microfinance by the RBI and the regulatory framework needed to achieve these objectives."[55] It was formed to provide a national level response to the situation in Andhra Pradesh. Many of the Committee's recommendations have found their way into the 2011 Bill. In July 2011, six months after the Maelgem Recommendations were issued; the RBI released a draft microfinance regulation Bill for comment. Although a full analysis of the Bill will be set forth in Section 4 below, salient elements of the Bill are as follows:

- The Bill would legitimize private microfinance and microfinance institutions by defining both of those terms broadly, and the Bill delegates primary regulatory authority to the RBI.
- The Bill asserts precedence of national over state laws, providing the RBI with sole regulatory authority over microfinance activities in India and provides that any MFI registered with the RBI will not be subject to State legislation related to money-lending and

[54] M-CRIL India Indices of Microfinance 2011. Measures of Performance of the 24 largest MFIs.
[55] RBI. *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.* 2011. P. 1

usurious loans

- The Bill provides that MFIs can accept deposits—as well as remittances and insurance with respect to microfinance activities

The 2011 MFI Bill has been widely heralded as addressing most of the needs for microfinance reform. N. Srinivasan, writing for CGAP, called the Bill "comprehensive and well rounded."[56] David Roodman, writing for the Center for Global Development (CGD), remarked that "for an industry still reeling from the blow of last October (2010) AP ordinance, the draft looks like very good news."[57] M-Cril stated that the bill "represents a major step forward in the government's engagement with the microfinance sector."[58]

IV. APPLYING LEGAL FRAMEWORK CRITERIA ASSESSMENT MODEL TO DRAFT INDIAN MICROFINANCE BILL

This section provides a comprehensive overview of the 2011 Indian MFI Bill using a criteria assessment model developed by GIZ. In 2003, GIZ conducted a study of eleven regulatory regimes throughout Latin America, Asia and Africa, to identify trends and analytical frameworks that could be used to make microfinance legislation more effective.[59] This section adapts the assessment criteria model to guide the discussion of the various components of the 2011 MFI Bill.

A. The Main Characteristics of the Legal Framework

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[56] Srinivasan, N. *India's Microfinance Bill Answers Most Questions*. CGAP. 2011.
[57] Roodman, David. *Draft Bill Gives Indian Microfinance Industry a Shot at Reincarnation.* Center for Global Development . 2011. P. 1
[58] Sa-Dhan 2011 Newsletter. *M-CRIl's Comments on the Draft Microfinance Bill: A Major Step Forward for Financial Inclusion.* P. 1
[59] Staschen, Stefan, *Regulatory Requirements for Microfinance: A comparison of 11 legal frameworks in 11 countries worldwide.* GIZ, 2003. P. 1

1) *Names of Primary and Secondary Legislation*

The 2011 MFI Bill is designed to "provide access to financial services for the rural and urban poor and certain disadvantaged sections of the people by promoting the growth and development of microfinance institutions as extended arms of banks and financial institutions and for the regulation of microfinance institutions and for matters connected therewith and incidental thereto." [60]The 2011 MFI Bill defines a variety of terms in new ways that supersede earlier statutes. All terms that are not defined in Chapter I of the Bill but which are defined in the Reserve Bank of India Act 1934, the Banking Regulation Act, 1949, or the National Bank for Agriculture and Rural Development (NABARD) Act, 1981 will have the meanings assigned to them in those Acts. [61] The primary legislation providing for the regulation of the banking industry includes the Banking Regulation Act No. 10 of 1949 (amended through 2004) and the Reserve Bank of India Act of 1934 (amended through 2009). The NABARD Act No. 61 of 1981 created the NABARD. Until the 2011 MFI bill, the NABARD was the principal regulatory body for microfinance services and microfinance institutions. With the 2011 MFI bill, these powers now reside with the Reserve Bank of India (RBI). In addition to these three foundational acts, Appendix Two outlines the relevant legislation.

2) *Number of MFIs to be Prospectively Licensed Under the Law*

According to NABARD, and based on 2008 data, there are some 500 MFIs that will be prospectively licensed under the 2011 MFI Bill.[62] However, it should be noted that due to regulatory overlap and the lack of published data on MFIs in India, that number is difficult to

[60] 2011 MFI Bill. P.1
[61] 2011 MFI Bill Chapter 1
[62] NABARD. http://www.nabard.org/microfinance/mf_institution.asp

corroborate.

3) *Supervisory Authority*

The 2011 MFI Bill makes a major change to the regulatory landscape for microfinance. No longer will MFIs be regulated by NABARD with other banks being regulated by RBI. This act stipulates that the sole regulatory body for microfinance will be the RBI. Chapter 23 provides the RBI with a wide range of responsibilities including formulating policy, setting benchmarks and performance standards, developing credit rating norms, specifying the form and manner of accounting and business operations, creating an appropriate database, facilitating institutional development of all entities through capacity building and training, promoting customer education, promoting sector related research and disseminating information related to fair practices (ensuring affordable cost to eligible clients). [63]

Two important innovations in the 2011 MFI Bill include the establishment of a Microfinance Development Council and State Advisory Councils. The Microfinance Development Council (MFDC) will be formed to "advise the Central Government on formulation of policies, schemes and other measures in the interest of orderly growth and development of the microfinance sector, and to promote financial inclusion". [64] The Council will be composed of stakeholders from the government ministries, the RBI, the Small Industries Development Bank, NABARD, the National Housing Bank and six members, of which two shall be women with "experience in microfinance.[65]" The objectives of the council will be to develop innovations in microfinance, establish credit information bureaus, and monitor grievance

[63] 2011 MFI Bill. Chapter 21.a-l
[64] 2011 MFI Bill. Chapter 3
[65] 2011 MFI Bill Chapter 4 a-g.

redressal mechanisms to protect microfinance customers.[66]

The State Advisory Councils (SAC) are to be established to advise the Central Government on progress related to consumer protection, providing an early warning system to the government on whether client protection mechanisms are functioning. For example, it will monitor over indebtedness, large scale defaults, assess whether collection practices are fair and reasonable, provide reports on progress with respect to financial literacy and inclusion, and monitor whether the grievance redressal mechanisms are functioning properly. [67] Both the MFDC and SAC provide safeguards against usurious lending, in theory. However, the ability of the Councils to truly function as early warning and monitoring systems remains unproven.

4) *Degree of Delegation of Rule-Making Power*

The Bill provides the RBI with the authority to issue directives related to a wide range of issues, including ceilings on the amount of loans and number of MFI clients, tenure of financial assistance, margin caps, maximum APR, creation of credit information bureaus, a code of conduct to be formulated by self-regulatory organizations, provision of a client protection code, advice to MFIs on management practices, and norms for corporate governance, prudential norms, etc. [68] Although the RBI is the primary regulator, the RBI may, with the approval of the Central Government, delegate any of its powers to NABARD in respect of any MFI or class of MFIs.[69]

5) *Delineation of regulatory tiers/windows*

The 2011 MFI bill creates a clear regulatory window for MFIs through the low minimum capital requirement and high capital adequacy requirement (85% according to MFI priority

[66] 2011 MFI Bill Chapter 6. I-iv
[67] 2011 MFI Bill. Chapter 8. 3a-3d
[68] 2011 MFI Bill. Chapter 24. a-q
[69] 2011 MFI Bill Chapter 38.1

sector lending status circular). It allows MFIs to accept small deposits. It provides, however, that commercial, regional rural banks and cooperatives are not covered by the Bill. The Bill also forces “systematically important” MFIs (those with more than Rs. 100 crores or 22.4 million loan book) which are currently trusts or societies to convert to more transparent organizations like NBFC-MFIs. [70]

B. Entry Requirements for New MFIs

1) *Minimum Capital*

The 2011 Indian MFI bill stipulates that each applicant must maintain a net owned fund, created out of contributions to capital, reserves, grants or donations, of at least five lakh rupees (approximately 10,209 USD), or such other amount specified by regulation.[71] This would appear to be a very low minimum capital requirement. One would expect therefore to see many very small MFIs registering under this Bill, which may cause increased oversight requirements for the RBI.

2) *Documentation*

The 2011 MFI Bill establishes that any MFI, in existence at the commencement of this Act, shall apply in writing to the RBI for a certificate of registration within three months of the effective date of the legislation. [72]

3) Required Legal Forms

[70] Ghosh, Samit. *The India Microfinance Bill- The Good and the Bad.* CGAP. 2011. P. 2.
[71] 2011 MFI Bill. Chapter 21.g
[72] 2011 MFI Bill. Chapter 11.1

As mentioned previously, MFIs may be legally registered as an NGO (society, trust or Section 25 Company) or an NBFC, but not as a cooperative. The restrictions on systematically important MFIs will help to ensure greater transparency as disclosure requirements for these firms are quite stringent. [73]

C. Main Sources of Information for the Supervisory Authority

1) *Content and Frequency of Off-Site Reports*

The 2011 MFI Bill requires each MFI to prepare a balance sheet, and profit and loss statement, at the end of each calendar year. [74] These financial documents must be audited by a “duly qualified” person. [75] If upon the review of annual accounts or any returns submitted by an MFI, the RBI determines that activities are being conducted in a manner prejudicial to the interests of its clients, the RBI may pass an order directing such MFI to cease and desist. [76] Additionally, every MFI shall file with the RBI a return containing particulars of its activities within 90 days of commencement of the Act. [77] Lastly, Chapter 40 provides the Central Government, in consultation with the RBI, with the power to call for a diverse range of information related to any MFI. [78]

2) *Provisions with regards to on-site inspections*

The RBI, or an inspection authority approved by the RBI, may at any time inspect books

[73] Asher, Mukul and Shankar, Savita. *Why the Microfinance Bill is a Good Move.* Sa-Shan. Micro Matters. 2011. P. 3
[74] 2011 MFI Bill. Chapter 18.
[75] 2011 MFI Bill. Chapter 19.
[76] 2011 MFI Bill. Chapter 13.1.
[77] 2011 MFI Bill. Chapter 22.
[78] 2011 MFI Bill. Chapter 40.

and records of an MFI. [79]In general, the RBI is given complete power over the closure and winding up of any MFI that it deems to be conducing activities to the "detriment of its clients."[80]

[79] 2011 MFI Bill. Chapter 26.1.
[80] 2011 MFI Bill. Chapter 26.4.

D. Restrictions on Permissible Activities

1) *Permitted or Prohibited Financial Products*

Chapter 21.f defines a "micro finance institution" as an entity (irrespective of its organizational form), which provides microfinance services in the form and manner prescribed, but does not include National Banks, Regional Rural Banks, or cooperative societies. Chapter 21.g of the 2011 MFI Bill defines microfinance services as one or more of the following financial services involving small amounts provided to individuals and groups:

- Providing microcredit
- Collection of thrift (savings)[81]
- Remittance of funds
- Providing pension or insurance services
- Any other services as may be specified

E. Ownership and Corporate Governance Requirements

1) *Capital Adequacy/Leverage ratio*

The 2011 MFI Bill provides regulatory power to the RBI to specify prudential norms, including adequate capital based on risk weights for assets and deployment of funds. [82]

2) *Limitations on Ownership*

The 2011 MFI Bill does not specifically speak to limitations on ownership. However, these provisions will default to the legislation pertaining to the legal form of the entity.

[81] Thrift is defined in Chapter 21.p as "any money collected other than in the form of current account or demand deposts, by a MFI from members of SHGs or any other group of individuals by whatever name called, who are availing financial services provided by such MFI. "

[82] 2011 MFI Bill. Chapter 24.m.

3) *Provision of Internal and External Audits*

The RBI is provided the power to require an audit of any MFI when it is "necessary in the public interest or in the interest of its clients or for the purpose of proper assessment of the records and books of account of the MFI".[83] An audit is required annually, but the RBI can ask for special audits at any time.

4) *Reserve and Liquidity Constraints*

The 2011 MFI Bill provides that every MFI shall create a reserve fund and transfer net surplus or profit to the reserve fund before any dividend is declared or surplus is utilized for any other purpose. [84]

5) *Interest Rates, Profit Margin Caps and Annual Percentage Rate (APR)*

Interest rates are capped at 26% per annum. Margins are capped at 12% above borrowing cost + a 1 % processing fee (not included in the interest rate or margin cap). For the first time the concept of APR is used in the industry to demystify the pricing of loans. [85] The RBI has the power to impose an APR cap. According to CGAP, the discussion of margin caps in Chapter 25, leads one to believe that the margin cap will be imposed across the sector and the APR will be used only in "exigencies".

6) *Other Performance Measures*

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[83] 2011 MFI Bill. Chapter 20.
[84] 2011 MFI Bill. Chapter 17.1.
[85] Srinivasan, N. *India's Microfinance Bill Answers Most Questions*. CGAP. 2011. Annual Percentage Rate (APR) provides a measure of the compounded and cumulative interest rate over the course of a year. The hope is that this will assist potential borrowers at understanding the true total interest rate that they will be required to pay.

General power is provided to the RBI to issue a variety of directions to MFIs related to setting benchmarks and performance standards pertaining to methods of recovery, management and governance and business conduct, credit rating norms, accounting standards, developing an appropriate database, customer education, and sector related research. [86]

F. Additional Issues

1) *Sanctions and Corrective Action*

The Bill proposes a maximum penalty for MFIs of 5 Lakhs or $11,000[87] per violation which seems insignificant considering the level of damage that an MFI may inflict on clients.

2) *Thrift*

The types of activities deemed financial assistance include the provision of thrift. Thrift is defined as any money collected other than in the form of current account or demand deposits by a MFI from members of SHGs or any other group of individuals. [88] The question remains as to exactly what the RBI means by thrift, and how to ensure depositor protection. Both of these questions remain unexplained by the 2011 MFI Bill.

3) *MFI Fund*

The 2011 MFI Bill calls for the establishment of a microfinance development fund to provide loans, refinance, grant, seed capital or any other financial assistance to any microfinance

[86] 2011 MFI Bill. Chapter 23.
[87] 2011 MFI Bill. Chapter 32.1
[88] 2011 MFI Bill. Chapter 2.h

institution or any other agency which the RBI may by regulations specify, give grants or loans for training, and invest in equity or other form of capital. [89]

V. APPLYING SELECTED BASEL CORE PRINCIPLES TO DRAFT 2011 INDIAN MFI BILL

The following is a brief comparison of the 2011 Indian MFI Bill with a sample of Basel Core Principles on effective banking practices. The purpose of this section is to provide an analysis of the benefits and costs of the 2011 Indian MFI bill based upon recently developed microfinance best practices.

A. Principle 2 (Permissible activities) and Principle 3 (Licensing criteria)

"The types of permissible microfinance activities should be clearly defined in laws or regulations and tied to the size of the institution and its ability to manage risks inherent with such products and clients. Permission to engage in sophisticated activities should be substantiated by management's experience and ability to identify, control and mitigate more complex risks. Also, the supervisory or licensing authority should maintain and publish a current list of licensed/supervised MFIs, and remain alert to and have the authority to deal with the illicit provision of financial services." [90]

1) *Does the 2011 MFI Bill Provide for a Clear Registration Process?*

The 2011 MFI Bill sets out key registration criteria for all MFIs. The Bill requires all institutions, regardless of form, to register with the RBI even if they are already registered with the RBI as an NBFC.[91] The reason for excluding cooperative societies accepting deposits from the definition of MFI is not clear. While registration is required, and except with respect to

[89] 2011 MFI Bill. Chapter 30. 3 a-f

[90] Bank for International Settlements. *Microfinance Activities and the Core Principles for Effective Banking Supervision,* Basel Committee on Banking Supervisions. 2010. P. 3.

[91] Rai, Vineet. *India's Microfinance Bill Offers Mixed Bag for Investors.* CGAP. 2011. P. 2.

certain restrictions on very large MFIs, the regulations do not tailor regulatory requirements to the sophistication or experience of the MFI.

2) *One Regulator?*

The 2011 MFI Bill establishes the regulatory supremacy of the RBI for the microfinance sector, resolving most political and regulatory ambiguity.[92] The Bill clearly keeps MFIs outside the purview of state based money lending laws, and provides for supremacy of the RBI and national legislation vis-à-vis state based legislation. This clarification should reduce the possibility of legislation like the AP ordinance, in which a state took matters into its own hands, causing confusion and chaos in the sector. Specifically, the Bill declares that any microfinance institution shall not be treated as a money-lender for the purpose of state legislation relating to money-lenders and usury. [93] However, the introduction of the State and National Councils could cause regulatory confusion. While the RBI is the primary regulator of the industry, the Councils are responsible for advising Central and State governments with respect to certain aspects of microfinance activities.[94] The exact role of the Councils vis-à-vis the RBI is still unclear.

3) *Permissible Activities and the Tricky Issue of Thrift*

The 2011 MFI Bill defines microfinance activities somewhat ambiguously with the only true differentiator from normal banking being the fact that their activities involve "small amounts."[95] This definition does not exclude a normal financial services company from offering

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[92] Bank for International Settlements. 2010. P. 2.
[93] 2011 MFI Bill Chapter 42. (Explanation)
[94] Roy, Shubbho, Renuka, Sane, and Thomas, Susan. *An economic policy and legal analysis of the Microfinance Institutions Bill, 2011.* IGDR Finance Research Group. Bombay, India. 2011. P. 9.
[95] 2011 MFI Bill. Chapter 2.g

microfinance. [96] The 2011 MFI Bill provides a forward- looking range of permissible activities, including micro insurance, savings products, remittances and pensions. It also recognizes group and individual lending models. [97] The conditions under which savings products may be offered are not delineated. [98]

Roy et al. views the lack of clarity on thrift as especially dangerous considering that a bill that allows financial institutions to carry out *banking-like* activity would create regulatory arbitrage and *increase* systemic risk. [99] Furthermore, there is a contradiction between deposits being collected from members of SHGs, or any other group of individuals, while other microfinance services can be provided to individuals or groups. This raises the question: Can thrift be collected from an individual or not?

B. Principle 7 (Risk Management Process)

[Legislation] should be tailored to identify, measure and manage microfinance risks – supervisors need to develop specialized knowledge and tailor supervisory techniques to risks in microloan portfolios and other products[100]

1) *Does the RBI Have the Capacity to Manage the Risk?*

Given the low initial capital requirement prescribed for MFIs, the large number of MFIs that may register could stretch the regulatory capacity of the RBI. [101]The Bill gives the RBI broad powers to issue directives on various matters related to the sector, including interest rates, margins, codes of conduct, and norms of corporate governance. It may be very difficult for the

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[96] Roy, Shubbho, Renuka, Sane, and Thomas, Susan.. P. 15.
[97] Asher, Mukul and Shankar, Savita. *Why the Microfinance Bill is a Good Move.* Sa-Shan. Micro Matters. 2011. P. 3.
[98] Ibid. P. 3
[99] Roy, Shubbho, Renuka, Sane, and Thomas, Susan. 2011. P. 9.
[100] Bank for International Settlements. 2010. P. 3.
[101] Asher, Mukul and Shankar, Savita. 2011. P. 4

RBI to assume such a significant role in regulating and supervising microfinance. No real cost and benefit analysis seems to have been undertaken related to the myriad functions to be performed by the RBI. According to Roy et al., there is no estimate of the financial impact of this bill on the government or the RBI. [102] I could also not find any such study but perhaps there are plans to do so. The establishment of a complex regulatory structure should be accompanied by a mechanism to pay for the regulatory costs, but no salaries for staff are permitted to be paid out of the fees collected under the Bill's provisions—the fees are predominantly designed to provide financial assistance to, and investments in, MFIs. [103]

Supervisors should adopt a risk-based approach to the implementation of Principle 18 (Abuse of financial services), which should be tailored to the risks posed by low-value microfinance operations. [104]

2) *A Closer Look at Penalties*

The provision on criminal conduct makes violation of every section, rule, regulation or order a criminal offence. On the other hand, consumers have no recourse to civil or criminal courts without the permission of the RBI. According to Roy et al., this creates a situation where the end consumers have very few legal remedies *if the regulator does not act.* [105]

VI. APPLYING SOCIAL PROTECTION MODEL DEVELOPED BY CGAP TO DRAFT 2011 INDIAN MICROFINANCE BILL

The Social Protection Model (SPM) developed by CGAP sets forth critical components of strong consumer protection principles, which are summarized by the chart below. This section

[102] Roy, Shubbho, Renuka, Sane, and Thomas, Susan. 2011. P. 10.
[103] Ibid. P. 10
[104] Ibid. P. 4.
[105] Roy, Shubbho, Renuka, Sane, and Thomas, Susan. 2011. P. 10.

reviews whether the 2011 Indian MFI bill meets "current standards" related to consumer protection.

Figure 1: Social Protection Framework

Adapted from Forster, Lahaye and McKee, *Implementing the Client Protection Principles.* CGAP, 2009

A. Avoidance of Client Over-Indebtedness

Proposal: The 2011 MFI bill provides measures to help protect customers against usurious lending, including interest caps, margin caps, transparent pricing, capacity building, etc. Specifically, the 2011 Priority Sector Status establishes a cap on "indebtedness of the borrower" at Rs. 50,000. In addition to these caps, the Bill provides for the creation of state advisory councils which are intended to act as early warning systems, alerting the RBI and the Central Government of high indebtedness.

Challenge: The challenge will be whether the RBI can effectively monitor client over-indebtedness. At the root of the problem is the large population in India that has minimal levels of financial literacy. As more and more of these individuals have experience with financial products, financial literacy is likely to increase. However, there will always be some customers who do not access financial literacy training, and who will take on more loans than they are able to service.

B. Mechanisms of Redress of Grievances

Proposal: One of the key reasons for the current crisis in Indian microfinance is the stated belief of the Andhra Pradesh Government that clients were not being treated fairly. The Bill provides for a grievance redressal mechanism[106] which will be a collaborative partnership between RBI, the Microfinance Development Council and the State Advisory Councils. These entities are permitted to appoint as many ombudsmen as are needed to resolve complaints. The Bill gives RBI the power to require MFIs to comply with a Code of Conduct to be developed by a self-regulatory organization.

Challenge: Implementing these client protection mechanisms on the ground may be extremely costly. There are substantial questions with respect to how such complaint resolution mechanisms will be monitored and evaluated with the large number of MFIs that will be registered under the Bill. Policies and procedures to govern the complaint resolution process have yet to be set forth in detail. Resolution of grievances in accordance with established rules and procedures is a central element of any consumer protection process and only time will tell

[106] 2011 MFI Bill Chapter 31 (1) and Chapter 8 (3.C)

whether the authority in the Bill to establish such mechanisms will be followed up with demonstrable and effective action.

C. Transparent Pricing

Proposal: The 2011 Microfinance Bill establishes that MFIs shall communicate to every borrower, the APR, comprised of the annual interest rate (26% cap), processing fees (2% cap) and any other charges or fees levied by the MFI, and will incorporate the same distinctly and prominently in the loan document obtained from the borrower.[107]

Challenge: The challenge will be whether the MFIs will effectively explain the information that is provided to the borrower. It is certainly helpful to require that such information be provided to the borrower, but if the prospective borrower does not understand the meaning of concepts described in the information such as compounded interest rates and multiple processing fees for multiple loans, the RBI will have difficulty ensuring that clients are protected against illicit lending practices.

D. Appropriate Collections Practices

Proposal and Challenges: The AP Ordinance essentially eviscerated the MFIs ability to effectively collect upon a default. Quite surprisingly, the 2011 MFI bill does not contain an adequate response to this problem. Unfortunately, the Bill says nothing related to the protection of clients against illegal collection practices and does not provide guidance to lenders on

[107] 2011 MFI Bill. Chapter 25.2.

permitted collection procedures. Thus, critical components of consumer protection and lender rights with respect to collection procedures are missing from the 2011 MFI Bill.

CONCLUSION AND RECOMMENDATIONS

The draft 2011 MFIB provides a sound starting point for comprehensive regulation of microfinance activities in India. The Bill seeks to strike a balance between promoting microfinance activities while enhancing consumer protection of microfinance customers. In this sense it provides a starting point for a balance of social costs and benefits to MFIs and consumers. The Bill makes strides in eliminating regulatory confusion by defining a clear registration process, establishing the RBI as the sole regulator of microfinance institutions and activities and eliminating the threat of duplicative and inconsistent regulatory requirements that could arise from state legislation.

It remains to be seen, however, whether the more detailed regulations and requirements to be issued by the RBI will follow through on the Bill's initial promise. Education of consumers with respect to financial literacy, enforcement of the Bill's provisions with respect to lending practices, insisting on adequate capital levels and, perhaps most significantly, the development of effective and credible complaint resolution mechanisms are aspects of the legislation that are yet to be "fleshed out". Effective implementation of these parts of the legislation are key to its ultimate success, and are necessary if the regulations are to meet the standards established for microfinance regulation by international best practices frameworks.

Finally, as with any regulatory framework, adequate funding must be made available to ensure that knowledgeable regulators are put in place to implement the legislation and enforce its provisions. In the end, the issue will be whether the political and regulatory leaders in India believe that microfinance, and its financial inclusion benefits, are a high enough priority to justify the funds and commitment necessary to make the promise of the Bill a reality. Further research will be needed to judge how the Draft 2011 Bill is implemented on the ground and how the different actors interpret and act on the provisions set forth in the 2011 MFI Bill.

APPENDIX 1: INTERNATIONAL FRAMEWORKS FOR MICROFINANCE REGULATION

1. CGAP: Microfinance Consensus Guidelines 2003 and the Revised Edition for Public Comment 2011

In 2003, CGAP developed a series of guiding principles for regulation and supervision of microfinance called the *Guiding principles on regulation and supervision of microfinance.*[108] The goal was to provide guidance on generally accepted principles of microfinance regulation. In 2011, CGAP updated the guidelines to reflect developments in microfinance since 2003. The revised principles emphasize that 1) poor people want and need financial services, and 2) that

[108] See Peck, Robert Christen; Lauer, Kate; Lyman, Timothy and Richard Rosenberg *Microfinance Consensus Guidelines: A guide to Regulation and Supervision of Microfinance*. CGAP 2003.

appropriate regulation and supervision of financial services is critically important to bringing these services to the poor. [109]

2. IADB: Principles and Practices for Regulating and Supervising Microfinance 2004

Similar to the CGAP guidelines, the IADB published a series of principles and guidelines on the effective regulation and supervision of MFIs. [110] The guidelines focus on the unique situation of Latin America, where many countries have had laws related to microfinance for years. The guidelines distilled eight major principles related to microfinance regulation. Legislative and regulatory institutions are urged to supervise only deposit taking intermediaries, allow only incorporated MFIs to take deposits, to not create new and distinct institutional forms for microfinance, encourage private investment, create distinct standards for risk classification, utilize risk based supervision that focuses on governance and ownership, lending methodology and internal controls, and encourage the development and use of credit bureaus.

3. Basel Committee on Banking Supervision: Microfinance Activities and the Core Principles of Effective Banking Supervision 2010

The *Core Principles for Effective Banking Supervision* includes twenty-five Core Principles developed by the Basel Committee as a reference for banking supervision. The Basel Committee on Banking Supervision provides a forum for cooperation on banking supervisory matters. [111] It is a sub-unit within the Bank for International Settlements. In 2010, the Basel Committee issued a consultative document focused on how the *Core principles for effective banking supervision* could be tailored for microfinance. Mr. Nout Wellink, Chairman of the Basel Committee and President of the Netherlands Bank, noted that "given the unique characteristics of microfinance and the range of practices on regulating and supervising this line of business, the guidance will assist supervisors in applying the Core Principles in a manner that is commensurate with the type, complexity and size of depository microfinance activities conducted in their jurisdictions".[112]

APPENDIX 2: LEGAL FORMS FOR ELIVERY OF MICROFINANCE SERVICES IN INDIA

Legal Form	**Relevant Legislation**	**Covered by 2011 Draft Bill?**	**Additional Explanatory Notes (If necessary)**
NGO (Societies and Trusts)	• **Indian Trust Act, No.2 1882** • **Societies Registration Act No.21, 1860**	Yes	NA

[109] Peck, Robert Christen; Lauer, Kate; Lyman, Timothy and Richard Rosenberg *Microfinance Consensus Guidelines: A guide to Regulation and Supervision of Microfinance*. CGAP 2011. Pp. 6.
[110] Jansson, T., Rosales, R. and Westley, G. *Principles and Practices for Regulating and Supervising Microfinance.* 2004. Washington, D.C.: The Inter-American Development Bank. http://www.iadb.org/sds/doc/principlenpract.pdf
[111] Bank for International Settlements. “About the Basel Committee.” Basel, CH. 2011. Accessed November 11, 2011. (http://www.bis.org/bcbs/about.htm).
[112] Bank for International Settlements. Microfinance Activities and the Core Principles- Basel Committee Issues Final Paper. 2010. Accessed November 11, 2011., http://www.bis.org/press/p100830.htm

	• **Charitable and Religious Trusts Act 1920** • **Companies Act No. 1 Section 25 Excerpt**		
NBFC	• **Master Circular on Fair Practices for NBFCs, 2009**	**Yes**	The Master Circular established guidelines for fair practices of NBFCs pertaining to loan terms and conditions, including annual interest rates. [113]
Cooperatives	• **Multi State Cooperative Societies Act No. 39, 2002** • **Andhra Pradesh Mutually Aided Cooperative Societies Act, No. 30, 1995**	**No**	The Cooperative Societies are registered as cooperative societies or mutual benefit societies or mutual aided societies under State laws.
Regional Rural Banks (RRB)	• **Regional Rural Banks Act No. 21, 1976**	**Yes**	NA
Commercial Banks	• **Banking Regulation Act of 1934** • **Banking Regulation Act No. 10**	**Yes**	NA
SHGs	• **National Bank for Agriculture and Development Act No. 61, 1981**	**Yes**	NA

[113] RBI. Master Circular. Fair Practices Code. RBI/2009-10/15. DNBS (PD) CC NO. 153/ 03.10.042/2009-10. Vii.

APPENDIX 3: RELEVANT LEGISLATION FOR MICROFINACNE SERVICES IN INDIA

Legislation Name	Type	Date of Enactment	Notes
• **Consumer Protection Act No. 68** • **RBI Circular on Grievance Redressal Mechanism** • **Code of Banks Commitment to Customers** • **Master Circular on Fair Practices for NBFCs**	• **Act** • **Circular** • **Code of Conduct** • **Circular**	• **1986** • **2008** • **2009** • **2009**	According to a CGAP Consumer Protection Diagnostic Report, over 5 million complaints were registered in 2007-2008. [114] However, until the 2011 MFI bill, practically all consumer protection legislation was directed towards commercial banks and regional rural banks (RRBs). The 2011 MFI Bill adapts the Grievance Redressal Mechanism, enacted through DBOD. NO. LEG BC. 81/09.07.005/2007-2008, to MFIs. In addition the Bill used the precedent set by the Mas
Banking Regulation Act No. 10	**Act**	**1949**	This forms the basis for baking regulation in India and is drawn upon substantially for the creation of the 2011 MFI draft bill
Circular Priority Sector Status of Loans to Microfinance Institutions	**Circular**	**2011**	The Circular on Priority Sector Status of Loans to Micro Finance Institutions (MFIs) (RPCD.CO.Plan BC. 66 /04.09.01/2010-11) lays out requirements for microfinance loans to qualify for priority sector status and thus to count toward the percentage of total lending advances to priority sectors that commercial banks must meet. These requirements apply both to bank lending to MFIs for on-lending to individuals or directly to members of Self-Help Groups (SHGs) or Joint Liability Groups (JLGs).
Master Circular on Microcredit	**Circular**	**2011**	This master circular consolidates a range of RBI policy statements on NBFCs and SHGs
Andhra Pradesh Ordinance	**State Ordinance**	**2010**	The 2010 AP ordinance which was one of the causes of the microfinance crisis

[114] CGAP. *Consumer Protection Diagnostic Report- India 2010*. Pp. 18.

			in 2010

Note: Many MFIs have also joined umbrella self-regulatory organizations including Sa-Dhan and Micro Finance India Network (MFIN). Under pressure from RBI, MFIN has created a code of conduct to prevent over-lending to individual borrowers. MFIN plans to form ombudsmen offices to address grievances, while Sa-Dhan, which has traditionally been more focused on the SHG model, has also developed a variety of best practices and financial management guidelines.[115] M-Cril is the main credit rating agency in India, and it is an important source of data and analytics with respect to the Indian microfinance sector. [116]

[115] See Sa-Dhan: The Association of Community Development Finance Institutions. Accessed November 24, 2011. http://www.sa-dhan.net/Inner.aspx?Others/ResourceCentre.htm
[116] See M-CRIL. Microcredit Ratings Limited. http://www.m-cril.com/Default.aspx

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