What should regulation do in the field of micro-finance?

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How to lend to a household?

1. Lend against collateral
2. Lend based on future cashflows
   1. A stable income
   2. Prospects of business income.

All these are hard, when dealing with poor people in India.

The key innovation

- Joint Liability Group
- Group members have a repeated game against the lender
- Group members have a repeated game against each other
- This yields very high collection rates despite no collateral, no credit analysis of the individual, and very little enforceability of the loan.

Connecting this to organised finance

- Micro-finance firm setup as a non-bank corporation
- It organises the ground-level activities of giving out loans, and doing collections
- It connects up to the upstream : debt financing from banks (albeit forced lending)
- It obtains equity financing from institutional investors and the IPO market.

Apart from one distortion – forced lending by banks – this is fully a market-based mechanism.

This was starting to show significant numbers

Fraction of households who have borrowed from a source

Income group	Annual income	Bank	SHG / MFI
Rich - I	1367	18.0	0.1
Rich - II	834	16.8	0.6
HMI - I	479	22.8	2.1
HMI - II	292	20.0	1.9
HMI - III	209	14.2	2.3
MI - I	148	12.9	4.1
MI - II	108	10.4	6.0
LMI - I	77	7.3	7.0
LMI - II	49	5.2	7.7
Poor - I	31	4.6	7.0
Poor - II	19	3.1	6.7

Quite remarkable, for a tiny and young industry to make a dent compared with gigantic banks which had tried to do this for decades.

The question

The positive

- A new industry
- Dramatically made progress on getting loans out to the poor, while banks had floundered for decades
- Power of innovation, power of finance, power of private sector
- Made banks and state government programs look ineffective
- Andhra Pradesh the poster child.

The concerns

- MFIs charged less than the money lender but they still charge a lot
- Coercion by peers was the foundation of high collections
- Making money while serving the poor
- A disaster waiting to happen.

Andhra Pradesh Crisis I: 2005

- Confrontation between the MFI industry and the AP government
- 50 branches of 2 major MFIs were closed down by the government
- "Usurious interest rates and forced loan recovery practices"
- An informal agreement was negotiated.

Andhra Pradesh Crisis II: 2010

- State government programs continued to lose market share
- SKS IPO
- A new law shut down collections
- Essentially 100% default
- Effectively, the state government told borrowers to default *en masse*, and they did.
- The MFI industry in AP is dead and will likely not come back to life for a long time.

Crisis transmission outside AP

- This could have just been an AP problem
- Problem: MFIs in AP were funded by banks
- Indian banks have relatively simplistic risk assessment approaches – they decided to cut off debt financing *to all MFIs*
- When the flow of new lending from an MFI chokes, it spoils one leg of the repeated game (between group and firm).
- As a consequence, MFIs all over India got into a funding crisis

Key questions

- What is the role of the State in the field of micro-finance?
- What are the market failures, and how can financial regulation address them?
- Consumer protection?
- Micro-prudential regulation?
- Systemic risk? (Answer: No)

What is different about micro-finance?

- The MFI is a financial service provider that lends to the poor, and it is a professional actor in the wholesale market where it borrows.
- In the former role, there is a need for consumer protection.
- In order to foster better credit assessment in the wholesale market, there is a need for better information.

What the AP crises has taught us

- Lending to the poor is dangerous
- Political problems take place at the level of the state government
- Lenders should be diversified across states

What should financial regulation do?

- Consumer protection of the micro-borrower
- Enhance credit information to cover *groups*, not just individuals
- Establish standards for disclosure about securitisation pools, so that wholesale lenders / bond investors can understand them.
- Stave off political problems at the state level to the extent possible.

How the Indian story evolved

Malegam Committee Report
: Focused on micro-prudential regulation of banks, who were lending to banks. Also systemic risk concerns.

The Micro-finance (Development & Regulation) Bill, 2011
: Views MFIs as 'extended arms of banks and financial services'.
RBI will be the micro-prudential regulation.
Redressal mechanism for households – but not a full consumer protection framework.
Envisages MFIs will take in deposits and become banks.

Conclusion

- Many decades of government interference in finance has not delivered financial inclusion
- Innovation + private-led finance held the key
- But there is a genuine problem of consumer protection
- Absent a full framework of consumer protection covering all finance, there will be some bad eggs
- Extreme responses by the state government
- Policy responses - not informed by a modern approach to financial regulation
- Consolidate the regulatory framework across all financial services

Thank you

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