MFI regulation: facilitate growth, strengthen supervision

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[2] Presented at "Microfinance: Translating Research into Practice" a conference hosted by *RBI's College of Agricultural Banking*, Pune, and *the Center for Micro Finance*, Chennai.

Goals of regulation

- Financial sector regulation executes a well-defined mandate. In India, this mandate broadly include three-points:
  - Prudential regulation – monitoring and management of systemic risk.
  - Protection of the “small investor”.
  - Development of the sector.
- From these perspectives, does the MFI sector need a regulator at this time?
- If so, what should be the mandate for this regulator?

MFIs: structure and reach

The MFI sector in India

- MFIs share the micro-credit space with bank-led SHGs.
- The business is heterogenous:
  1. **NBFCs** (60% of market loans, 12% of the number of MFIs)
  2. Trusts
  3. Societies
  4. NGOs/Non-profit firms
- The sources of funds are less so:
  1. Donors
  2. **Domestic commercial banks + DFIs** (more than 90% of the funding)
  3. Equity finance

  Each of these are part of the formal financial sector.

  Each are equipped to evaluating and take risk of the above MFI entities.

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Lessons from the AP episode, Sep 2010

What happened in AP

- Sep-Oct, 2010: Newsreports about several suicides by MFI borrowers.
- State government response:
  - Stop all MFIs from collection ;
  - Force registration of MFIs at district level;
  - Force code of conduct for collections on offices and followed by loan officers;
  - Force all collections to be done at local govt. premises;
  - Force shift to monthly repayment schedules
  - Pass an ordinance in December 2010 to make these the law

  This is state intervention in the way MFIs do business.
- In contrast:
  - Dec 2010, newsreports about several suicides by farmers in AP due to inability to pay loans after crop failure.
  - State policy response: Monetary compensation to their families.

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Country-wide impact

- MFIs faced a severe liquidity crunch when banks stopped all funding to the sector.
  This is true today all over the country, with no apparent differentiation regarding whether the MFI portfolio had exposure in AP or not.
- MFI industry response: Revisit the "Microfinancial sector (Developement and Regulation) Bill" – pending since 2007.

  1. Definitions of micro-finance; who eligible customers are; Sets eligibility criteria for the industry in the form of networth, accounting and corporate governance principles.
  2. No explicit mandate to "protect the rights of the MFI customer".
  3. Splits development vs the prudential regulation function between a "Micro Finance Dev elopment Council" vs. the NABARD.
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A bird's eye view of the impact on the MFIs

- Factors that created the crisis could be listed as:
  - Inherent risk of working with the very poor.
    The poor have far lower recourse to redressal than the rest of the country, and any business must explicitly consider this.
  - Lack of deniability/validation exacerbated by lack of organised data from the industry (claims of usurious loan rates cannot be refuted very readily).

  What was new in 2010:
  - Political risk translated into action on the sector as a whole.
  - Increased operational risk because of different states adopting different interventions ("Money Lending" being a state subject).
- This led to a an extreme loss of liquidity when uncertainty about the sector rose and lenders stopped loans.
  It revealed how vulnerable the sector is to lending sources – typical of *financial intermediation*.

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What the crisis means for MFI policy

- Principles of *prudential regulation* could not have helped prevent this crisis.
- One reason for the banking sector to withdraw support:
  - The MF Industry cannot readily refute claims of high lending rates, nor offer organised/trusted base of data/research to refute claims of coercive collection practices.
  - AP intervened legally to force a change on the business processes of MFIs.
    In politically sensitive issues, there is a high probability that other states follow suit.
  - These changes impact upon the cost of doing business for the MFI.
    High costs effects the expected rate of return/higher expected risks slows funds flows.
- As a consequence, lenders stopped fund flows to MFIs.
- More troublesome is how long the impact has lasted.
- What could be done to mitigate such an impact?

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1. Protecting the rights of the consumer is paramount

Mitigating risks of working with the poor

- *Prevention*: A strong industry focus on protecting the interests of the MFI customers.
  Legal wisdom: The procedure should be such that not only is justice done, it is also *seen to be done*.
- Some possible *solutions*:
  - The MFI Bill (2007) can explicitly link the Consumer Protection Act (1986) to define a process of customer dispute redressal at the taluka/village level.
  - The bill can consider using the same process to implement fair practices in debt collection.
  - The bill can define the industry standard of bankruptcy procedure for micro-borrowers.
  - The industry association can adopt the UID as a way to reduce the costs of KYC as a way to show lower transactions costs.

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Could regulation have helped?

- Industry norms can be put in place to safe-gaurd the interests of the micro-borrower/customer of micro-financial-services.
- However, an independent entity with the mandate of micro-financial-customer protection could go a long way to
  - reach consensus on how it is to be done, and
  - operationalise processes to become effective rapidly.
- However, implementation of a national regulation appears difficult, though not impossible.
  - The legislation governing credit is the "Money-Lenders Act", which is a List-2 subject.
  - There is more hope on regulation of the more generic "intermediation of financial services".

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Managing political risk

- Persistent observation from both insiders and the public: poor organisation of/access to customer level data in MFIs.
- *Solution*: One time cost of creating a credit bureau for the micro-borrower would be of great benefit to the industry.
- This could be a great source to manage political (and lender) risk with:
  - consistent periodic dissemination of reports on micro-credit quality.
  - on-demand reports on micro-credit quality, specific to regions.
  - Cautionary note: need to simultaneously protect the privacy of the micro-borrower.
- More needs to be done by way of publicly accessible data and research.
  The effort put into place after the 2006 AP episode needs to be scaled up.

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Can regulation help?

- Industry associations can do this.
- However, an independent regulator can be more effective in rapid execution.

2. Systemic risk – Non-diversified funding sources

MFI Lesson 2010: funding risk

- In financial market regulation, a key principle of systemic risk management is to
  - monitor concentration and
  - manage these by setting limits.
- The Indian MFI sector has always had a variety of firms, as well as lenders.
- Upto 2006, there was low industry concentration across firms, even though lending was mostly from the banking sector.
- This has changed significantly over the last three years.

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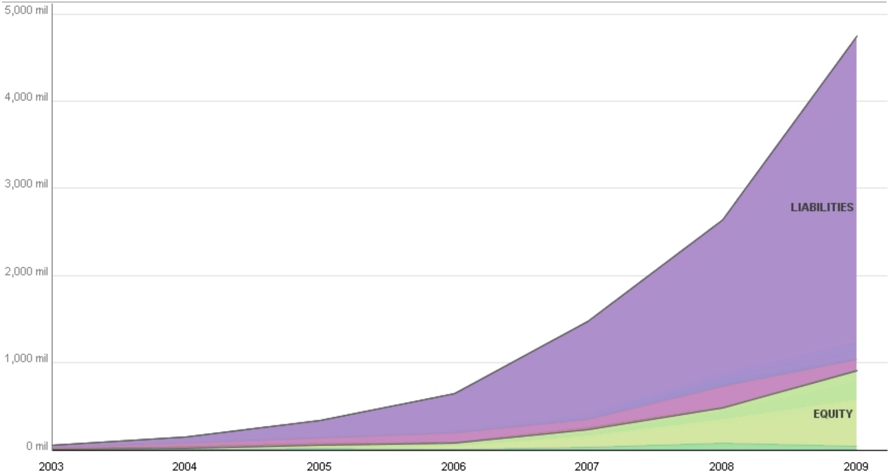
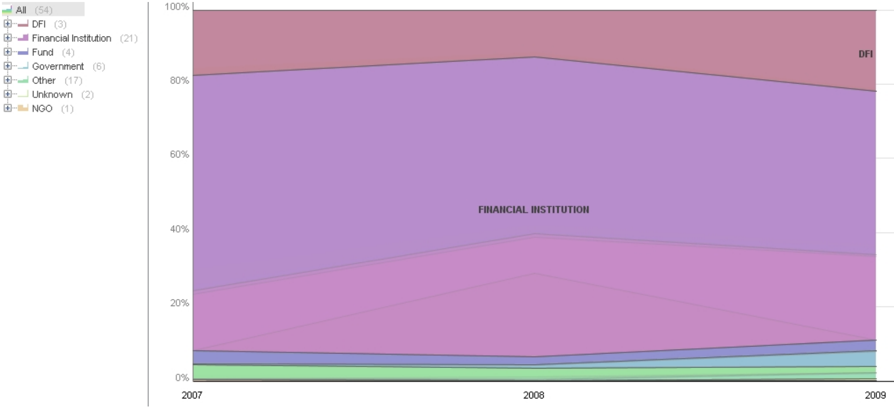
Size of the MFI industry



Source: `http://www.mixmarket.org`

MFI funding sources



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Managing funding risk using regulation

- The previous graphs offer a useful dichotomy on the question of prudential regulation:
  - The regulated sector, or entity, must not pose risk to the entire financial sector.
  - The entire regulated sector itself must not become at risk.
- In either case, there is a strong case for an independent entity focussed on solutions to resolve it.
- For instance, the current (2010) liquidity crisis has continued over four months and is expected to continue. An independent "regulator" is the logical entity to interface with the (bank) lenders, backed by the legal powers to negotiate terms for the sector.

Managing funding risk using securitisation

- Today, institutional lending comes only from banks.
- Alternative participating financial institutions such as pensions, insurance, mutual funds, who would prefer investing in securities rather than loans.
- One form: securitise credit portfolios of the MFIs.
- This requires a development of (a) legislation for creating these securities, (b) accounting norms, (c) bankruptcy norms.
- While there are international guidelines, these need to be adapted to the Indian context.
- A "regulator", with a development mandate and focussed on maintaining prudential levels of concentration risk, would be the ideal entity to put this development in place.
- Such "regulated products" would find more ready acceptance in the rest of the financial sector than one proposed by individual entities.

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In summary

A MFI regulatory mandate

- An optimal policy response ought to focus on protecting the rights of the micro-finance customer: Consumer protection, Debt collection, Bankruptcy process.
- If a MFI regulator is created, a mandate could be:
  - Protect the rights of the micro-borrower/small financial services customer.
  - Prudential norms for the MFI wrt managing systemic risk. Monitor the quality and risks of the MFI sources of funds portfolio, with a viewpoint to understanding concentration of funding risk.
  - Development of the MFI sector to achieve scale. This involves work on two fronts:
    - Promote innovation in products/services to the customer – linkages between MFI and the customer.
    - Promote innovation in linkages to the formal financial sector – linkages between MFI and the source of funds.

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A MFI regulatory mandate

- An optimal policy response ought to focus on protecting the rights of the micro-finance customer: Consumer protection, Debt collection, Bankruptcy process.
- If a MFI regulator is created, a mandate could be:
  - Protect the rights of the micro-borrower/small financial services customer.
  - Prudential norms for the MFI wrt managing systemic risk. Monitor the quality and risks of the MFI sources of funds portfolio, with a viewpoint to understanding concentration of funding risk.
  - Development of the MFI sector to achieve scale. This involves work on two fronts:
    - Promote innovation in products/services to the customer – linkages between MFI and the customer.
    - Promote innovation in linkages to the formal financial sector – linkages between MFI and the source of funds.

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Possible ways forward:

- *next three–six months:* improve the transparency of the MFI industry to monitor concentration of risks – design a standard and simple information set and test it in the field;use securitisation to broaden the possible source of funds to MFIs; offer a plan of better supervision and monitoring to negotiate with the MoF and RBI to improve liquidity conditions.
- *next one year:* use the CPA framework to improve consumer protection and debt collection processes; define bankruptcy information and processes for the micro-borrower; have a full-fledged credit bureau in place that covers 85% of the industry.
- *next three years:* put in place an independent regulator for financial product and services distribution monitoring and supervision.

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Thank you.