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

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Comparing Indian and U.S. Corporate Governance,
Financial Regulation and Intellectual Property Rights
ISB, Hyderabad

31 May 2012
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.
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

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

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

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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.
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.
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.
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.
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.
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