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Regulating Microfinance: A Suggested Framework

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It is time to address regulatory issues to enable the microfinance sector to contribute more effectively to the goal of financial inclusion, and to provide an environment in which all stakeholders can participate with confidence.

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India with a population of around 300 million poor people has emerged as a large potential market for the microfinance sector, which is attracting funding from various sources. To enable the country to leverage this interest and use it to progress towards the goal of financial inclusion, it is important to develop a regulatory structure for the sector, for a number of reasons. First, regulation is needed to enable microfinance institutions (MFIs) to offer savings services, the lack of which is a major shortcoming of the sector. Second, with the entry of commercially-oriented participants, the need for supervision and consumer protection is even more pressing. Third, with MFIs broadening their range of services to include services such as insurance and pension products, coordinated regulation of the sector is required. Finally, given the diversity of legal forms of MFIs, a uniform regulatory framework would enable a level playing field and prevent regulatory arbitrage.

Challenges of Regulation

The lending models used in microfinance have peculiarities and hence its regulation poses certain unique challenges.

First, MFIs may not pose systemic challenges in the sense that it is unlikely that even the largest MFIs are "too big to fail". They however deal with low-income groups least likely to be able to bear downside risks. Hence in a democratic country, politically MFIs may be "too sensitive to fail". The implicit contingent liabilities are on the State, making their effective regulation in the interest of the government.

Second, while banks usually have to make full provisions for loans without collateral, such a measure is not possible in the case of MFIs, as most of their loans are collateral free. On-time repayments on microfinance loans, however, tend to be high, though experience shows that once a loan is overdue, the ultimate collection of the loan is less likely, than in the case of loans that are backed by collateral (Rosenberg 2008). As a result, provisioning already delinquent loans needs to be more aggressive for microcredit loans as compared to other loans.

Third, while bank failures may be contagious due to the interdependent nature of the payments system, the interdependencies between group members in microfinance can lead to a different kind of contagion effect. Widespread defaults can occur either if some members start consistently defaulting or if there are rumours of MFI failures. An important incentive for repayment of collateral free MFI loans is the ability to obtain larger loans in the future. Any event which makes the possibility of future loans reduce considerably, has the potential to trigger widespread defaults. A regulator of MFIs therefore has to be highly sensitive to these realities.

Fourth, MFI customers are often first time users of financial services and usually have low education. The responsibility on the MFI to offer the right products which suit their members' needs as well as provide adequate financial education and training to them is considerable. Regulation needs to necessarily oversee this important element of MFI operations.

Fifth, merely formulating regulation regarding codes of conduct for MFIs and providing channels for dispute resolution regarding MFI practices is not sufficient. Moreover, the channels need to be easily accessible and MFI customers need to be made aware of them.

Sixth, the cost that MFIs would incur in complying with regulation needs to be considered, as it may have an impact on their lending rates.

Regulation of any financial institution, including an MFI, needs to encompass prudential and non-prudential issues. The first relates to issues regarding solvency of the institution, important to maintain confidence in the financial system and protect depositors. The second includes all other matters such as guidelines on interest rates, truth-in-lending laws and anti money laundering rules.

The Consultative Group to Assist the Poor's (CGAP)[1] guidelines on microfinance regulation favour a clear distinction between the supervision of depository (deposit accepting) and non-depository MFIs, as the former require closer monitoring. Housing the supervision of non-depository MFIs separately helps avoid confusion regarding which MFIs are being monitored closely. The guidelines suggest that deposit-taking MFIs should be supervised by the authority which supervises commercial banks, so as to leverage existing supervisory skills and reduce incentive for regulatory arbitrage. The supervisory staff needs however to be trained in the particular portfolio characteristics of MFIs.

Prudential Issues

These include minimum capital limits, capital adequacy requirements and loan loss provisions. A minimum capital limit is usually set which is often used as a rationing device in order to keep the number of MFIs to be supervised within manageable limits (Rosenberg 2008). Capital adequacy requirements are based on the premise that capital acts as a cushion against possible losses for depositors and creditors. Similarly, loan loss provisions are required so as to build reserves to provide for future losses. The peculiarities of MFI portfolios discussed earlier need to be taken into account while setting these requirements.

Non-Prudential Issues

Regulation encouraging transparent disclosure of interest rates, offering appropriate financial products, fair selling practices and methods for collecting loans come under non-prudential regulation of MFIs.

Often interest rate caps are also suggested as interest rates in microfinance are observed to be higher than in the case of most other loans. Transaction costs arising from doorstep delivery of the loan, when computed as a percentage of the small loan size do contribute to the high rates charged. Capping the interest rate can lead to undesirable outcomes such as exclusion of needy customers whose profiles call for interest rates in excess of the cap. Moreover, a uniform interest rate cap could create incentives for MFIs to stay away from difficult and new geographies, where transaction costs are higher. Determining and enforcing appropriate interest rate caps could also be difficult as financial products are inherently complex. There is a possibility that MFIs may be encouraged to repackage loan contracts by varying repayment schedules, fees and other aspects such that effective interest rates remain the same.

One of the most important non-prudential issues is transparent disclosure of interest rates. Often, interest rates charged by MFIs involve upfront fees and service charges, making calculation of effective interest rates complex. Moreover, sometimes rates are calculated on a flat basis and not on a diminishing balance basis. Such practices are also observed in India. A study by Porteous (2006) of mature microfinance markets highlighted the importance of requiring MFIs to quote interest rates in a uniform manner in contributing to reduction of rates over time. Non-prudential microfinance regulation in India needs to address this issue.

Proposed Model for Regulation

It is only recently that most countries have started seriously addressing microfinance regulation. Hence, the possibility of learning from the experience of other countries is limited.

The policy with regard to microfinance in India has been largely positive and developmental and at the same time marked by caution and prudence. While the policy has brought the sector to its current state of development, in order to enable the sector to grow further in an orderly manner, certain major policy initiatives need to be taken.

The most important missing link in the country's financial inclusion efforts is that of adequate saving channels for the poor. While commercial banks, regional rural banks and post offices, have good geographical networks, they are often unable to provide the doorstep collection of small deposits on a regular, frequent basis as required by the low income groups. These groups are usually unable to visit formal financial institutions during specified working hours without incurring considerable transaction costs in terms of time and money. MFI operations on the other hand are tailored to more effectively meet their requirements and hence they should be permitted to provide savings services. While the "business correspondent" model attempts to increases savings avenues for the poor, large MFIs which have the scale required to provide these services in an economic manner, have not been adequately incentivised to participate in it.

The other important missing link in the country is that of affordable remittance and payments services. Mobile banking provides the greatest scope for this to take place. In Philippines, a typical transaction through a bank branch which costs $2.50 is estimated to cost only $0.50 when automated using a mobile phone (*Asian Banker* 2007). In Kenya, the success of M-PESA, the mobile money scheme launched by Safaricom, its largest mobile operator has nearly 7 million users out of a total population of 38 million (*The Economist* 2009). The benefits for customers include quicker and cheaper transfer of money and a means to save small amounts of money for emergencies. The huge customer base and powerful brand of the mobile company enabled outreach to unbanked segments of the population. As regulators in many countries do not permit non-bank entities to offer banking services, other models have developed. For example, in Uganda, a leading mobile company has partnered with a bank to offer a similar service (*The Economist* 2009).

It is proposed that to address these two missing links, some of the large MFIs should be selectively permitted to be converted to a special category of MFI banks with lower initial capital requirements. These MFI banks should be permitted to offer savings as well as mobile payment services.

Given the large geographic area of the country, licences to collect deposits need to be provided selectively to entities, so as to enable effective regulation. Regulators should assess an MFI thoroughly based on financial, management and operational criteria. These entities should also have the capability to increase outreach substantially and reap economies of scale and scope, with the potential to lower costs of microfinance services. Large MFIs who have a satisfactory track record are possible likely candidates. After a licence is provided, continued supervision and monitoring of these entities is called for.

It may be desirable to extend deposit insurance to MFI bank depositors, though it may also create moral hazard issues. In any case, the contingent liability of the savings collected is likely to be on the State given India's political economy characteristics, making their regulation important for the government.

Permitting MFI banks to partner with mobile companies to offer mobile banking services has the potential to enable access to remittance services to a large number of unbanked customers. While the banks have a relationship with these customers and are best placed to service them, the mobile companies have the technology and expertise required. Such collaborations can bring down transaction costs considerably.

The creation of MFI banks amounts to allowing entry to private well-governed deposit-taking small banks as recommended by the Raghuram Rajan Committee on Financial Sector Reforms (2008). As suggested by the committee, these banks will be in closer touch with customers and will provide tailor made products and services to them.

As small banks tend to be geographically focused, the Rajan Committee suggests offsetting their higher risk by imposing on them more stringent regulations. Higher capital adequacy norms, stricter prohibition on related party transactions and lower allowable single party transactions have been suggested. While the last of the three may not be applicable in the case of MFIs which usually have large number of small borrowers, the first two suggestions should be considered in developing regulatory norms for MFI banks. As recommended by the committee, the supervisory capacity should be developed to deliver the greater monitoring these newer banks will require.

The Reserve Bank of India (RBI) would be an appropriate choice for prudential regulation of MFI banks, as it is the regulator for banks in India. This may stretch the regulatory capacity of RBI but would nevertheless be a worthwhile investment for the country as in the long run it could result in large-scale financial inclusion and financial deepening. Training a team of officials at RBI on various microfinance models and the peculiarities of microfinance regulation as well as the intricacies of prudential regulation will be required.

The non-prudential regulation of MFIs may be carried out by an independent regulator in the nature of an oversight board (OB) reporting to the RBI, so as to not to overstretch the regulatory capacity of RBI. The board should be broad-based in nature consisting of representatives from government, banks, MFIs, SHG federations, Sa-Dhan, NGOs and consumer forums.

MFIs of all legal forms should be required to register themselves with this regulator and adhere to the uniform code of conduct prescribed. The code should cover truth in lending, transparency with regard to charges, financial education, selling appropriate financial products, practices for monitoring and collection as well as norms for provisioning of loans.Channels for customer complaints and dispute resolution should also be provided and creative communication should be used to explain their availability to SHG and MFI members.

The OB should coordinate with other financial sector regulators, for instance, with IRDA and PFRDA, with regard to insurance and pension services. The members of the OB should have the requisite expertise as a group and access to public and private sector experts. This can be accomplished through appropriate advisory committees. The above recommendations effectively amount to having two regulators. For prudential supervision of MFI banks, regulation by RBI is proposed. For non-prudential supervision for the sector as a whole, an independent OB reporting to the RBI is suggested.

The creation of regulatory capacity for prudential and non-prudential regulation of the Indian microfinance sector will be a major challenge, but is likely to be a worthwhile investment for the country as in the long run, it could result in large-scale financial inclusion and financial deepening.

NOTE

1 The Consultative Group to Assist the Poor is an international consortium of public and private development agencies.

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