MICROFINANCE AND THE INDIAN ECONOMY

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Abstract

This paper offers a critical survey of the microfinance and its co relation with Indian economy. The literature so far suggests moderate but not transformative effects of microfinance in the Indian economy. However, the steps taken by the Government to support the system of microfinance looks promising. The paper seeks to explore the prevalent regulatory structure of the sector, the lacunas of the regulations and recommends the dynamic changes required for well-being of the industry and in turn the development of Indian economy.

Introduction

"Microfinance can be defined as attempts to provide financial services to households and micro-enterprises that are excluded from traditional commercial banking services. Typically, these are low-income, self-employed or informally employed individuals, with no formalized ownership titles on their assets and with limited formal identification papers."[i]

Microfinance = Micro (small) + Finance (system of circulating money by way of loans). Microfinance is a way to promote economic development of the country, creation of employment and growth through the support of small times entrepreneurs. Microfinance was introduced with a 'not for profit' motive by the father of microfinance - **'Muhammad Yunus'**.

The poor in India do not have adequate access to the formal banking sector. Inaccessibility of the poor to the formal banking sector is mainly due to the following reasons:

- Lack of retail banking services for the poor,
- Lack of assets with the poor that could be used as collaterals and
- Illiteracy of the poor.

The poor require financial assistance for short term, medium term and long term. However sadly, the commercial banking structure of our country failed to understand the loan requirements of the downtrodden. This pulse of the poor was correctly tapped by small-time loan houses that were willing to risk their capital by advancing money for short term and as well for small value to the needy.At present there are more than 100 Scheduled Banks[ii], 349 District Cooperative Central Bank (DCCB)[iii], 27 State Rural Livelihood Missions[iv] and over 5000 non-profit organisations (NGO)[v] engaged in promoting the business of microfinance within the country[vi].

Evolution of Microfinance in the Indian economy:

The service like microfinance was much needed in the ever-growing poor population of India. Further poverty led to issues like illness, incomplete education, untimely deaths, and women harassment and lastly increase in the crime rate. All such situations urgently needed a system that would financially support the poor masses. Also, Microfinance was much needed as the formal banks refused to grant loans to people below poverty line.

By 1980s, the Indian Government had understood that the existing banking policies, procedures and systems were not meant to meet the requirements of poor; that they were forced to borrow from the unruly unorganized sector – moneylenders, pawn agents etc. Around that time, based on the success of the Grameen Bank, National Bank for Agriculture and Rural development (NABARD)[vii]borrowed the idea and recommended alternative policies, systems and procedures to be formulated to aid the poor population of the country striving to make hands and mouth meet and to save them from the clutches of moneylenders. Thus, microfinance was introduced in banking sector.

The economic crisis of 1980s also shifted the focus from the basic philosophy of “no profit motive” to the fact that the system was “commercially viable”. The model was capable of making profits and at the same time it was a sustainable business providing the required credit facilities to the poor.

It is worth noting that even before formal introduction of microfinance by NABARD, private groups, NGOs had already started working for the financial upliftment of the poor section of the society. In early 1970s, Mrs. Ela Bhatt started the Self-Employed Women’s Association (“SEWA”) of the state of Gujarat formed an urban cooperative bank, called the Shri Mahila SEWA Sahakari Bank, with the objective of providing banking services to poor women employed in the unorganized sector in Ahemadabad, Gujarat.

In contrast to formal banking, Microfinance is a small size, shorter duration loan. There is no requirement of collateral security and lengthy procedures. The basic difference between the two is that the banking system is a purely commercial organization whereas the objectives of Microfinance are more social enhancement in nature.

The highlights of the microfinance scheme are:

- Loans are provided without collateral security
- Loans under this scheme are provided particularly to people under the poverty line.
- Based on the belief that the poor people will not default the loan amount
- Such tool is required for socio-economic development for upliftment of the weaker section.

REGULATORY LANDSCAPE OF MICROFINANCE IN INDIA:

The era of Globalisation witnessed rapid growth of Microfinance institutions within the country. With the growth came the fraudulent practices. The sector faced a major downfall in the year 2010 and this can be majorly contributed to the shortcomings of the regulatory framework of the microfinance sector. With the Microfinance sector at a standstill, there was a pressing need for new regulation to address issues of this sector.

This forced the Government of India, in December, 2010, to enact an Ordinance known as **Andhra Pradesh Microfinance Institutions (regulation of money lending) Act, 2010**. Further, the Reserve Bank of India (RBI) appointed a RBI sub-committee known as the "Malegam Committee[viii]" headed by Shri. Y.H. Malegam.[ix] The Committee recommended regulations in 2011 and these regulations were accepted by RBI. Later the Government of India introduced **Micro Finance Institutions (Development and Regulation) Bill 2012** on May 22, 2012 to establish a regulator under RBI to regulate and supervise the activities of NGOs and MFIs.[x]

To simplify the regulatory process, Microfinance sector was classified into categories based on the organisation type. The categories are as follows:

1. Microfinance institute registered as a society under the Societies Registration Act, 1860;
2. Microfinance institute registered as a company under section 25 of theCompanies Act, 1956 and involved in Microfinance activities;
3. Cooperatives registered under the conventional state-level cooperative acts, the national level multi-state cooperative legislation Act (MSCA 2002), or under the new state-level mutually aided cooperative acts (MACS Act)[xi]; or
4. Microfinance institute registered as a trust established under the Indian Trust Act, 1882[xii];
5. Non-Banking Financial Companies (NBFCs) categorized as 'Non-Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) and complying with the norms prescribed as per circular DNBS.CC.PD.No. 250/03.10.01/2011[xiii] dated December 02, 2011.[xiv]

NABARD – The Sole Regulator:

As there was variety in the types of institutions and their regulation, there was demand for an independent regulator for the microfinance sector. The Government of India appointed NABARD as the only regulator for the microfinance sector.[xv]This was a notable feature as rather than setting up a regulatory body, the first institution in relation to the microfinance sector was given the responsibility. However, the biggest area of concern is that NABARD itself is a service provider. Making a service provider, the market regulator is contrary to good governance practices.

The provisions concerning the regulator for the microfinance sector are inconsistent with the CGAP guidelines.[xvi]

- The 2007 Bill designated NABARD as the single regulator for both depository and non-depository institutions, while the guidelines suggest separate regulators for each.
- The guidelines, suggest that a central banking body such as the RBI should regulate depository institutions. In this way such MFIs would be held at the same pedestal as banks and NBFCs.
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The above-mentioned issues point towards having two regulators for the sector. While RBI would be the regulator for microfinance banks permitted to offer savings and other remittance services, there has to be supervisory control of someone else to set benchmarks for the industry to safeguard consumer interests. This framework addresses the systemic risk and the need for good governance and orderly development. It will also ensure that there is no conflict of interest between a service provider and a regulator. Consistent with the CGAP guidelines, in addition to effectiveness and cost of supervision, the socio-economic and regulatory context of India must be considered in deciding on the regulator for the micro-finance sector.

Recent regulations by RBI:

The Andhra Pradesh crisis compelled the RBI to set stringent regulations with regards to microfinance institutions. The highlights of these guidelines are:[xvii]

i. RBI directed the institutions to structure portfolios with 85% of net assets in qualifying microfinance assets;
ii. Standard loan form format to be followed by institutions across the country;
iii. Not more than two institutions can lend to same borrower;
iv. Set Rs. 1,00,000/- as maximum indebtedness of a borrower and loan amount restricted to Rs. 60,000/- for the first disbursement cycle;
v. Loans to be extended without collaterals;
vi. Minimum loan tenure to be 2 years and borrower can repay loan in weekly, fortnightly or monthly instalments;

MICROFINANCE AND UPLIFTMENT OF INDIAN ECONOMY:

Microfinance facilitates to generate money flow at rural areas since the cash flow reaches at lower levels. This helps all sectors of people such as weavers, blacksmiths, carpenters, etc. by providing different types of financial help. The decentralisation process minimises documentation regarding dispersal as it is diverted through self help groups. The underlying principle is mutual help through self help. In the process it is to be understood that money dispersed in rural areas are subject matter of agricultural farming and other rural income generation which is seasonal subject to weather conditions like drought, flood and so on. Hence the predictability of return of borrowings is always a subject matter of dispute in terms of settlement of dispersal. This instability is taken care of by the system of microfinance. The financial system in India has undergone a change after new economic policy adopting privatisation, liberalisation and globalisation. There are so many measures taken by the government to improve the economic condition of the nation in the global level. However all these measures cannot strengthen our financial system over night. It takes more time for the market to absorb all the above changes and to become more vibrant. Besides, the economic condition has to undergo a change with a higher percentage of economic growth. Only then it can be said that our financial system is developed and has started yielding positive results. N this regard microfinance will help in bringing more people into the growth of the economy by flow of money.

Suggestions for further strengthening the Sector:

1. **RBI and a new regulatory body:**
   Firstly, entrusting all the powers to NABARD as the sole regulator is not a very good idea as NABARD is already playing a major role as an apex Rural Bank and would invariably be biased towards its existing clients when it comes to management of issues. This leniency will hamper the growth of the sector in two ways:
   - will affect the normal course of duties of NABARD; and
   - will not create trust and confidence in the mind of urban poor.

   Hence the responsibility of managing Microfinance sector should be shouldered equally by the Central Government through RBI and also a separate body should be constituted. This body should only concentrate on the regulatory aspects of microfinance sector. A body similar to IRDA, TRAIshould be set up. This regulatory body will be solely responsible for managing the regulatory aspects of the sector. Further, the RBI should be entrusted the duty of timely checks and balances over the functioning of such body. This way there will be dual check on the institutions.

2. **Government recognition compulsory:**
   There are many institutions operating within the sector that are not recognised by the Government. This in turn excludes such institutions from the regulatory framework of the RBI. It is recommended that all the institutions carrying on the business of microfinance have to compulsorily get a 'certificate of commencement' from the Government before starting the business of lending. For those institutions that accept compulsory deposits, legislation providing for central-level government recognition could also include standards for segregation of these funds, to avoid putting them at risk of loss through poor investment decisions

3. **Setting up of a Microfinance Advisory Committee:**
   The committee should have members from Central Government, the RBI, NABARD and any other appropriate authority that the Central Government deems fit. The committee would formulate, advice on, and help implement policies with regards to introduction of innovative technology, client protection measures, credit information sharing and financial inclusion in the micro finance sector.

4. **Setting up of State Microfinance Body:**
   The proposed state regulatory bodies would be represented by members of state governments in co-ordination with the Central Government and the RBI. The role of this body would be to monitor, ensure compliance of RBI guidelines and coordinate with central government in matters related to operations of MFIs in states as well as in districts falling under the State's territorial jurisdiction. These bodies will ensure that there is at least one additional body monitoring the sector apart from the RBI and the suggested new regulatory body.

5. **Appointment of Ombudsmen[xviii]:**
Examples should be drawn from other sectors while establishing the office of Ombudsmen in every region. The consumers are totally unaware about the existence of any hierarchy to resolve their issues. Hence appointment of Ombudsmen will prove to be a welcome move to implement complaint redressing mechanism for consumers of the Microfinance sector.

6. **Consumer education:**
It is proved that the consumer of Microfinance services is sparsely aware of the regulations, grievance redressal mechanism, regulator etc that is already there at their disposable. A lot of mechanisms are rendered useless if the consumers either do not have information about them, or do not feel empowered to avail of them. A huge effort needs to go into educating the consumers about their rights within the industry, and their recourse under the law.
The Government has to take extra effort to educate the consumer about the available facilities through consumer awareness programmes, advertisements similar to the 'jaagograhakjaago'[xix] should be promoted.

7. **Stringent regulations with respect to Collection mechanism:**
To avoid any further scenarios like the Andhra Pradesh crisis, regulations should be inclusive to stop coercive and abusive collection techniques.
These include:
   - Sanctioning and disbursement of loans should be done only at a central location;
   - Field staff should not be allowed to make recovery at customer's place of residence or place of work;
   - All recoveries should be made at the group level;
   - More than one individual should be involved in sanctioning and disbursement;
   - Disbursement should be closely supervised; and
   - Institute should be subject to severe penalties if coercive methods of recovery are used.[xx]

In addition, the Government of India must take initiative to monitor microfinance system which would assist the lower income micro-entrepreneurs, resulting in an improvement in income earnings and expenditure leading them to enjoy a higher living-standard. Microfinance industry has attempted reaching the rural and urban poor and the attempt is to grant them loans to meet their regular expenses. Now it is time to promote and uplift the business ideas of the poor. Such micro-entrepreneurs should be given express loans to put their ideas in action. This is call for added regulations to have hold over this separate stream of loans. This step will certainly lead the country towards financial progress on the global map.

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References

[i]https://openknowledge.worldbank.org (assessed date September 27, 2019)
[ii] Scheduled Banks in India refer to those banks which have been included in the Second Schedule of Reserve Bank of India Act, 1934. Every Scheduled bank enjoys two types of principal facilities: it becomes eligible for debts/loans at the bank rate from the RBI; and, it automatically acquires the membership of clearing house.
Refer to: https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/RBIAM_230609.pdf (assessed date September 27, 2019)
[iii] District Cooperative Central Bank, popularly known as DCC Bank is a cooperative banking network established in India to serve cooperatives and rural areas.
[iv]State Rural Livelihood Mission is a poverty alleviation project implemented by Ministry of Rural Development, Government of India. This scheme is focused on promoting self-employment and organization of rural poor.
[v] a non-profit organization that operates independently of any government, typically one whose purpose is to address a social or political issue
[vi]Dr.Bhanwala H., *Status of Microfinance in India* p. 10 Chintala, Mumbai, 2017
[vii]NABARD's Mission: to promote sustainable and equitable agriculture and rural development through participative financial and non-financial interventions, innovations, technology and institutional development for securing prosperity.
[viii]Malegam Committee report available at:
https://rbi.org.in/scripts/PublicationReportDetails.aspx?ID=608 _ ((assessed date September 27, 2019))
[ix] Aim of the Malegam committee was to:

1. To examine the prevalent practices of MFIs in regard to interest rates, lending and recovery practices to identify trends that impinge on borrowers' interests.
2. To delineate the objectives and scope of regulation of NBFCs undertaking microfinance by the Reserve Bank and the regulatory framework needed to achieve those objectives.
3. To examine and make appropriate recommendations in regard to applicability of money lending legislation of the States and other relevant laws to NBFCs/ MFIs.
4. To examine the role that associations and bodies of MFIs could play in enhancing transparency disclosure and best practices.
5. To recommend a grievance redressal machinery that could be put in place for ensuring adherence to the regulations recommended.
6. To examine the conditions under which loans to MFIs can be classified as priority sector lending and make appropriate recommendations.

[x]Refer to https://indiamicrofinance.com/download-andhra-microfinance-ordinance-908172.html (assessed date September 27, 2019)
[xi] An Act to consolidate and amend the law relating to co-operative societies, with objects not confined to one State and serving the interests of members in more than one State was felt necessary by the individual States as well as by the Government. With these objectives, the Act was enacted.
[xii] Indian Trusts Act, 1882 is an Act in India related to private trusts and trustees
[xiii] For NBFC-MFI, refer to: https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=6857&Mode=0(September 27, 2019)
[xiv] The committee on NBFC-MFI suggested creation of a separate category of NBFCs viz; Non-Banking Financial Company-Micro Finance Institution (NBFC-MFI). Consequently, there would be following categories of NBFCs:

a. Asset Finance Company (AFC)
b. Investment Company (IC)
c. Loan Company (LC)
d. Infrastructure Finance Company (IFC)
e. Core Investment Company (CIC)
f. Infrastructure Debt Fund- Non- Banking Financial Company (IDF-NBFC)
g. Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI).

[xv] Role of NABARD as the regulator has been discussed in chapter 3.

[xvi] The Consultative Group to Assist the Poor (CGAP) is a consortium of 33 bilateral and multilateral donor agencies and private foundations working together to build sustainable financial services for the poor (known as "microfinance"). CGAP serves three major groups of clients:

1) financial service providers, including specialized microfinance institutions (MFIs), that serve the poor; 2) member donor agencies; & 3) governments.

To each client groups, CGAP provides advisory & technical services, training, research and funding for innovation, development of industry standards and guidelines, & dissemination of best practices.

The guidelines laid by CGAP are general in nature and each country is expected to evolve its own regulatory framework based on considerations of likely effectiveness and cost of supervision.

[xvii]https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=9827)

[xviii] an official appointed to investigate individuals' complaints against a company or organization, especially a public authority

[xix] As part of this initiative, the government has used multiple channels to create consumer awareness through Print media advertisements, Audio Campaigns, Video Campaigns,etc., are being used for consumer information and education about initiatives like Insurance Ombudsman channel. National Consumer Helpline has been set up by Ministry of Consumer Affairs, Government of India. Complaints can be registered online through the official website and through toll free number.

[xxxx] The Malegam Report. Reserve Bank of India. January 2011.
Refer to: www.sebi.gov.in/commreport/melagamreport.pdf