Micro Credit in India:
Overview of regulatory scenario

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Forbes brought a special issue on microfinance in December 2007 wherein it said: "microfinance has become a buzzword of the decade, raising the provocative notion that even philanthropy aimed at alleviating poverty can be profitable to institutional and individual investors." This revolutionary and pro-poor economic activity has been recognized worldwide as an efficient tool to combat poverty, create jobs and generate income. Above all, it has been regarded as a tool of financial inclusion – that is, including masses in the progress of mankind.

This article provides a quick view of the regulatory scenario of micro credit in India. This article is not a recommendation for regulation, but given the massive growth in micro credit in recent years, the explosion of micro credit dispensing institutions, and the application of risk transfer devices such as securitisation to micro credit, it is inevitable that there is some structured thinking on the institutional framework for micro credit. Regulation is something that is needed at a proper time – when the instrument is too mature to need pampering, and too immature to deserve total freedom. Jury is still out on the question whether that time has come in India.

What is Micro Credit?

Micro Credit is defined as *provision of thrift, credit and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards*. Micro Credit Institutions are those, which provide these facilities. (As per RBI Master Circular, 2008). Evidently, the word micro credit does not have an exact definition. For regulatory purposes, non-banking financial institutions enjoy exemption from the RBI Regulations if such institutions provide loans upto Rs 50000/-, and in case of loan for a dwelling unit, upto Rs 125000/- (NOTIFICATION No. DNBS.138/CGM(VSNM)-2000 dated January 13, 2000).

The concept of micro credit is known more by its approach than by monetary limits to the amount of loans. Of course, the target segment is the poorest, but Mohammed Yunus tried the concept of joint-liability or peer-pressure. Most micro credit loans are dispensed through village or community-level self-help groups (SHGs) who agree to create a pressure on the individual borrower to perform as per contract.

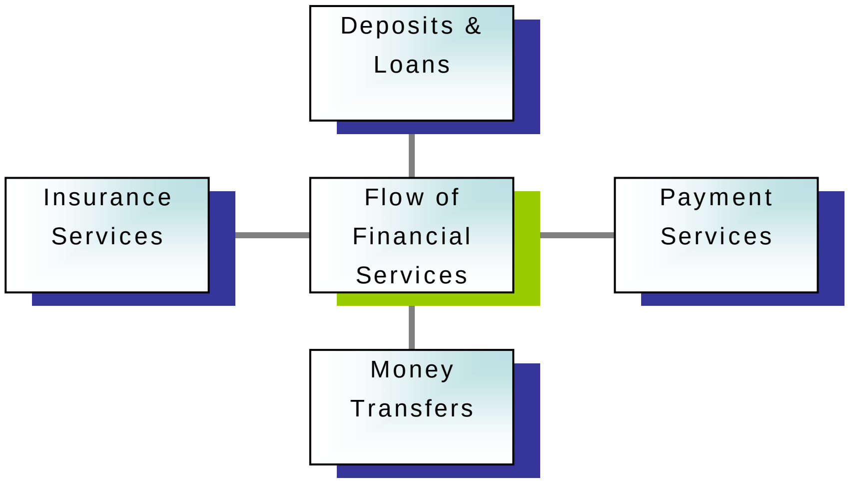
Difference between microcredit and microfinance:

The term Micro Finance is much broader than micro credit. The main components of micro finance are:

- deposits
- loans
- payment services

- money transfers
- insurance to poor and low-income households and their microenterprises

Thus, micro credit is only a component of the broad spectrum of micro financing. This article, however, focuses on micro credit.



MICROFINANCE

Origin of the concept

In 1974, Professor Muhammad Yunus, then a professor of economics, in Bangladesh was moved by the plight of people when the country faced a famine. Famine-struck “skeleton-like people began showing up in the railway stations and bus stations of the capital, Dhaka. Soon this trickle became a flood. Hungry people were everywhere. Often they sat so still that one could not be sure whether they were alive or dead. They all looked alike: men, women, children. Old people looked like children, and children looked like old people.”

Yunus felt guilty teaching economics in the cool comfort of this classroom in this scenario. “What good were all my complex theories when people were dying of starvation on the sidewalks and porches across from my lecture hall? My lessons were like the American movies where the good guys always win. But when I emerged from the comfort of the classroom, I was faced with the reality of the city streets.”

Yunus left the campus and went to Jobra, a village in Chittagong of Bangladesh, to learn a new method of banking for the poor. That is where he tried the idea of tiny loans for self-employment of the poor, and thus, the idea of micro credit was born. It is from here that it took the shape of Gramin Bank, Bangladesh, and thereafter, has spread all over the world.

The World Bank estimates at there are now over 7000 microfinance institutions, serving some 16 million poor people in developing countries. The total cash turnover of MFIs world-wide is estimated at US$2.5 billion and the potential for new growth is outstanding. It is estimated that, worldwide, there are 13 million microcredit borrowers, with US$ 7 billion in outstanding loans, and generating repayment rates of 97 percent. It has been growing at a rate of 30 percent annual growth. (Data Snapshots on Microfinance - The Virtual Library on Microcredit).

Special features of lending

Microcredit offers access to financial resources to the poorest of the poor in the rural areas. It allows people to undertake self- employment activities or to venture very small businesses without depending on money-lenders who demand exorbitant interest rates.

Currently there are following organisational forms of the MFIs, viz.,

- Banks
- Financial Corporations
- NBFCs regulated by the RBI
- Trusts, Societies, Co- Operative Societies and Section 25 companies
- Non- banking corporates

Such loans are collateral-free. Maturity is normally 50 weeks with repayment in weekly installments. The loans are under $25,000 and for entrepreneurs who have not been able to secure financing through traditional lenders. The purpose of these loans is to finance very small businesses either to finance working capital or to buy assets for the business. These loans can come with technical support such as business training also.

Micro-credit in India

Microfinance in India through its major channels served over 33 million Indians in the financial year 2007-08, up by 9 million over the last financial year, out of which around 80% clients were women. As on 31st March, 2008, outstanding microcredit portfolio of India Microfinance was about Rs. 22,000 crore, out of which 75% are accounted for by SHG- Bank Linkage Program, 20% by large MFIs and 5% by medium and small MFIs. India's MFIs operate in 209 out of 331 poorest districts of the country; up by 5% over the previous year. The Table below gives the volumes of MFIs, that is, excludes the volume of SFG-Bank linkage program.

The Microfinance Institutions (MFIs)

From The Bharat Microfinance Report 2008:

	MFIs with Loan Portfolio up to 5 crore	MFIs with Loan Portfolio >5 to 50 crore	MFIs with Loan Portfolio over 50 crore	**Total**	No of MFIs
Society	87.7	543.8	478.3	**1,109.70**	104
Trust	24	149.8	225.4	**399.3**	31
Cooperative Bank	8.3	-	-	**8.3**	8

MACS	5.2	11	-	**16.2**	10
Section 25 Company	11.6	127.4	543.6	**682.6**	22
NBFC	10.6	197.3	3,312.10	**3,520.00**	25
LAB or any other	13.6	13.7	134.7	**1,62.0**	16
Total	**161**	**1,043.00**	**4,694.10**	5,898.20	
No of MFIs	137	57	22		216

Source: **www.sa-dhan.net**

Microfinance evolved in India in the early 1980s with the formation of informal Self Help Group (SHG) for providing access to financial services to the needy people. The MFIs are organised under three models: SHGs, Grameen model/Joint liability groups and Individual banking groups as in cooperatives.

Over the past few decades, this innovative scheme has attracted a range of non-governmental and state-sponsored institutions. Leading financial institutions are the Small Industries Development Bank of India (SIDBI), the National Bank for Agriculture and Rural Development (NABARD) and the Rashtriya Mahila Kosh (RMK). A few NGOs like PRADAN, ICECD, MYRADA, SEWA have played a significant role in promoting micro-credit.

With micro-credit becoming financially viable, even commercial banks like ICICI Bank, ABN-AMRO, HDFC Bank, UTI Bank and international banks like Citibank have also entered the field. Non-banking corporates are participating as well.

Regulatory Regime

The picture of the regulatory regime below relates to the general regulatory powers applicable to different micro credit entities in India. This means that while there are no specific regulations applicable to micro credit, there are regulations applicable to the providers thereof. These regulations may be summed in the Table:

Categories of Providers	Legal Framework governing their activities
(a) Domestic Commercial Banks, Public Sector Banks, Private Sector Banks & Local Area Banks	(i) RBI Act 1934 (ii) BR Act 1949 (iii) SBI Act (iv) SBI Subsidiaries Act (v)Acquisition & Transfer of Undertakings Act 1970 & 1980
(b) Regional Rural Banks	(i) RRB Act 1976

	(ii) RBI Act 1934 (iii) BR Act 1949
(c) Co-operative Banks	(i) Co-operative Societies Act (ii) BR Act 1949 (AACS) (iii) RBI Act 1934 (for sch. banks)
(d) Co-operative Societies	(i) State legislation like MACS
(e) Registered NBFCs	(i) RBI Act 1934 (ii) Companies Act 1956
(f) Unregistered NBFCs	(i) NBFCs carrying on the business of a FI prior to the coming into force of RBI Amendment Act 1997 whose application for CoR has not yet been rejected by the Bank (ii) Sec. 25 of Companies Act
(g) Other providers like Societies, Trusts, etc.	(i) Societies Registration Act, 1860 (ii) Indian Trusts Act (iii) Chapter IIIC of RBI Act, 1934 (iv) State Moneylenders Act

At one point of time, the government had mooted the idea of a comprehensive regulatory instrument for micro credit institutions. As is common for most regulations, it is usually intended for development, but ends up in regulation, if not strangulation. The Bill was also opposed, particularly by the Left parties. We discuss below the history and some salient features of the Bill.

The Micro Financial Sector (Development and Regulation) Bill, 2007

In March 2008, the Finance Minister tabled the bill in the Lok Sabha, which was then referred to the Lok Sabha Standing Committee on Finance.

Key features of the Bill

It provides for the regulation and supervision of cooperative societies and non- profit institutions (including societies and trusts) that are providing microfinance. The regulator for all of these institutions would be the National Bank for Agriculture and Rural Development (NABARD).

- Microfinance is defined to include loans, savings, insurance and pension services. Loans cannot exceed more than Rs 50,000 (Rs150,000 for housing purposes).
- The bill defines an MFO (Micro Finance Organisation) as any organisation that provides micro-finance services and include societies, trusts and cooperative societies.
- All MFOs that accept deposit from ‘eligible clients’ need to be registered with NABARD. Minimum experience of three years and minimum net owned fund of Rs five lakhs has been fixed as a condition for registration.

- NABARD has to specify the form and manner of accounting of business operations of micro finance organizations.
- Registered MFOs will be required to submit reports to the regulator.
- MFOs will also be subject to inspection by the regulator in case of complaints of harmful practices.
- It also proposes to set up a corpus fund called the Micro Finance Development and Equity Fund for the development of the sector
- Every MFO that accepts deposits has to create a reserve fund by transferring a minimum of 15% of its net profit every year.
- The central government may establish a Micro Finance Development Council to advise NABARD on formulation of policies related to the micro financial sector.

The Lok Sabha Standing Committee on Finance raised many objections to this bill and suggested that the Bill needs to be dropped and an appropriate Bill needs to be evolved.

Master Circular on Micro Credit

The Reserve Bank of India has come out with a **Master Circular on Micro Credit** dated July 1, 2008, which pertains to bank lending and NBFC-lending activities in the micro credit segment. Some of the key features of the circular are cited below:

The Self Help Group (SHG) - Bank Linkage Programme

The NABARD launched a pilot project and supported it by way of refinance. The criteria has been laid down for selecting SHGs by NABARD. (http://www.nabard.org/)

The advances given by the banks to the groups were treated as advances to "weaker sections" under the priority sector. While the norms relating to margin, security as also scales of finance and unit cost would broadly guide the banks for lending to the SHGs, deviations therefrom could be made by banks, where deemed necessary.

As a follow up of the recommendations of the Working Group under the Chairmanship of Shri S.K. Kalia, the then Managing Director, NABARD, banks were advised in April 1996 as under:

- SHGs lending to be treated as a normal lending activity
- Banks to report their lending to SHGs and/or to NGOs under the new segment, viz. 'Advances to SHGs'
- Banks to include SHG lending within their Service Area Plan
- SHGs eligible to open savings bank accounts
- Banks were advised that the flexibility allowed to the banks in respect of margin, security norms, etc. under the pilot project would continue to be operational under the linkage programme even beyond the pilot phase.
- Keeping in view the nature of lending and status of borrowers, the banks may prescribe simple documentation for lending to SHGs.
- The bank loan may not be utilized by the SHG for financing a defaulter member to the bank.

- Training of the field level officials and sensitization of the controlling and other senior officials of the bank.
- Banks to closely monitor the progress regularly at various levels

Exemptions granted to NBFCs engaged in microfinance activities

It is decided to exempt such NBFCs which are engaged in (i) micro financing activities, (ii) licensed under Section 25 of the Companies Act, 1956 and (iii) which are not accepting public deposits from the purview of Sections 45-IA (registration), 45-IB (maintenance of liquid assets) and 45-IC (transfer of profits to Reserve Fund) of the RBI Act, 1934.

In view of the need to protect the interests of depositors, microfinance institutions (MFIs) would not be permitted to accept public deposits unless they comply with the extant regulatory framework of the Reserve Bank.

Interest rates deregulated

The interest rate applicable to loans given by banks to micro-credit organisations or by the micro-credit organisations to Self Help Groups/member beneficiaries would be left to their discretion.

Mainstreaming and enhancing outreach

- The banks may formulate their own model(s) or choose any conduit/ intermediary for extending micro credit. Micro Credit extended by banks to individual borrowers directly or through any intermediary would be reckoned as part of their priority sector lending.
- The criteria for selection of micro credit organisations are not prescribed. It may, however, be desirable for banks to deal with micro credit organisations having proper credentials, track record, system of maintaining accounts and records with regular audits in place and manpower for closer supervision and follow-up.
- Banks may prescribe their own lending norms keeping in view the ground realities.
- Micro credit should be included in branch credit plan, block credit plan and state credit plan of each bank. Micro credit should also form an integral part of the bank's corporate credit plan and should be reviewed at the highest level on a quarterly basis.
- A simple system requiring minimum procedures and documentation is a pre-condition for augmenting flow of micro credit.

Delivery Issues

- Banks should provide adequate incentives to their branches in financing the SHGs.
- The group dynamics of working of the SHGs may be left to themselves and need not be regulated.
- The approach to micro-financing of SHGs should be totally hassle-free and may include consumption expenditures.

Financing of MFIs by banks

- Competing MFIs were operating in the same area, resulting in multiple lending and overburdening of rural households.
- Many MFIs supported by banks were not engaging themselves in capacity building and empowerment of the groups to the desired extent.
- In many cases, no review of MFI operations was undertaken after sanctioning the credit facility.

These findings were brought to the notice of the banks to enable them to take necessary corrective action where required.

Total Financial Inclusion and Credit Requirement of SHGs

Banks are advised to meet the entire credit requirements of SHG members namely, (a) income generation activities, (b) social needs like housing, education, marriage, etc. and (c) debt swapping.

Transparency/ Disclosure Norms- Self Regulation

The Reserve Bank of India is understandably hesitant to directly regulate the disclosure practices of all Indian MFIs. As such, the RBI has largely left MFI regulation to the MFIs themselves. CGAP's MFI Disclosure Guidelines offer the best benchmark for judging institutional transparency. All Indian MFIs should work to comply with these guidelines.

Conclusions

No doubt, micro credit has come a long way. And still now it has a long way to go. Micro credit institutions have not been completely successful in its pursuits because of some inherent weaknesses and restraints. Speedy actions are needed to remove the obstacles to microcredit's development. Inadequate regulation is one element curbing this sector's healthy expansion. Considering the potential of the sector, a review of the Bill to rectify the above drawbacks is essential.

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