Y V Reddy: Micro-finance - Reserve Bank's approach

Address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Micro-Finance Conference organised by the Indian School of Business, Hyderabad, 6 August 2005.

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Friends,

I am thankful to the organisers for giving me this opportunity to be amidst this distinguished gathering. Since Dr. Bimal Jalan, a Member of Parliament and my distinguished predecessor, is chairing the session, let me start with his role in the subject of my special address today. The earliest reference to micro-credit in a formal statement of monetary and credit policy of Reserve Bank of India (RBI) was in Dr. Bimal Jalan's Monetary and Credit Policy Statement of April 1999. The policy attached importance to the work of National Bank for Agriculture and Rural Development (NABARD) and public sector banks in the area of micro-credit. It announced total deregulation of interest rates on loans by banks to micro-credit organisations and by these organisations to their members and beneficiaries except in the case of government sponsored programmes. Dr. Jalan, as Governor, continued to focus on this subject virtually in every one of his Annual and Mid-term Review of policy statements. In all these statements, the basic objective has been of mainstreaming micro-credit and accelerating the flow of bank credit to micro-finance institutions without jeopardising their decentralised, voluntary and non-bureaucratic character. Accordingly, the banks were urged to make all out efforts for provision of micro-credit, especially forging linkages with Self-Help Groups (SHGs), either at their own initiative or by enlisting support of Non-Governmental Organisations (NGOs). The micro-credit extended by the banks is reckoned as part of their priority sector lending, and they are free to devise appropriate loan and savings products in this regard.

I am delighted to continue the excellent tradition set by my predecessor in regard to micro-credit. Accordingly, RBI announced a policy framework in the Mid-Term Review of Monetary and Credit Policy of November 2003 based on interactive sessions with various stakeholders in the sector and reports of four Informal Groups. The framework urged the banks to provide adequate incentives to their branches for financing the SHGs, establish linkages with them, simplify the procedures while providing for total flexibility in such procedures to suit the local conditions. It was also made clear that the group dynamics of working of the SHGs may be left to themselves and need neither be regulated nor formal structures be imposed or insisted upon. NABARD was advised to reinforce its commitment to enhancing the flow of micro-credit while simplifying the process and to devise mechanisms to ensure sharing of experiences amongst the bank branches that were closely involved in extending micro-finance. In view of the interim report of the Task Force on Revival of Cooperative Credit Institutions (Vyas Committee), RBI clarified that micro finance institutions (MFIs) would not be permitted to accept public deposits unless they comply with the extant regulatory framework of the Reserve Bank.

The Annual Policy Statement of April 2005 noted the progress and targets of SHGs programme and indicated two measures to give further fillip to microfinance movement. First, access to External Commercial Borrowings was indicated for non governmental organisations engaged in micro finance activities. Second, the policy also announced that the modalities were being worked out for allowing banks to adopt the agency model by using the infrastructure of civil society organisations, rural kiosks and village knowledge centres for providing credit support to rural and farm sectors and appointment of micro-finance institutions (MFIs) as banking correspondents.

Review of developments

It must be recognised that considerable work had been done by the RBI in this sector since 1991 before making the formal policy announcements in 1999. In 1991-92, a pilot project for linking about 500 SHGs with banks was launched by NABARD in consultation with the RBI which advised the banks to actively participate in it. In 1994, the RBI constituted a Working Group on NGOs and SHGs. On the recommendations of the Group, the Reserve Bank advised that the banks' financing of SHGs would be reckoned as part of their lending to weaker sections and such lending should be reviewed by banks and also at the State Level Bankers' Committee (SLBC) level, at regular intervals. As a follow up of the recommendations of the NABARD Working Group, the RBI took a series of measures in April 1996 to give a thrust to micro-finance based lending, and these are worth recalling.

Banks were advised to consider lending to the SHGs as part of their mainstream credit operations, to identify branches having potential for linkage with SHGs and provide necessary support services to such branches while including the SHG-lending within their Service Area Plan. The Service Area branches, in turn, were to fix their own programme for lending to the SHGs with a view to enabling them to get the benefit of catalytic services of NGOs. The Service Area branch managers were asked to have an ongoing dialogue and rapport with the NGOs and the SHGs of the area for effecting linkage. Banks were also advised that SHGs, registered or unregistered, which engaged in promoting the saving habits among their members, would be eligible to open savings bank accounts with banks irrespective of their availment of credit facilities from banks. It was also decided that flexibility allowed to banks in respect of margins, security norms, etc., as part of the pilot project for savings-linked loans to SHGs would continue. Further it was decided that NABARD would continue to provide refinance to banks under the linkage project at the rates stipulated by NABARD. It was also decided that banks may charge interest on the finance provided to the Groups / NGOs for on-lending to SHGs at the rates indicated by the NABARD from time to time. Further, the SHGs were to be free to decide on the interest rate to be charged to their members, provided the rate of interest was not excessive.

While close coordination between the NABARD and the RBI characterised the growth of the micro-credit movement till 1999, the Government of India took an active interest in the subject as evidenced by the successive announcements in the Budget Speeches of Finance Ministers since 1999. However, the announcements related essentially to SHG programme, except in the budget speech of 2005 where there was a separate and distinct reference to MFIs, with a mention of a suitable legislation, though the thrust remains to be the linkage with the banks for providing financial intermediation. The budget speech states:

> "At present, micro finance institutions (MFIs) obtain finance from banks according to guidelines issued by the RBI. MFIs seek to provide small scale credit and other financial services to low income households and small informal businesses. Government intends to promote MFIs in a big way. The way forward, I believe, is to identify MFIs, classify and rate such institutions and empower them to intermediate between the lending banks and the beneficiaries. Commercial banks may appoint MFIs as "banking correspondents" to provide transaction services on their behalf. Since MFIs require infusion of new capital, I propose to re-designate the existing Rs.100 crore Micro Finance Development Fund as the "Micro Finance Development and Equity Fund", and increase the corpus to Rs.200 crore. The fund will be managed by a Board consisting of representatives of NABARD, commercial banks and professionals with domain knowledge. The Board will be asked to suggest suitable legislation, and I expect to introduce a draft Bill in the next fiscal year".

It must be recognised that the policy of expanding the thrust beyond micro-credit to the MFIs is not a reflection on the lack of progress in provision of micro-credit but a reiteration of its success and a possible approach to widening, deepening and strengthening micro-finance movement as a whole. The evolution of SHG Bank-Linkage Programme could be viewed in terms of three distinct phases, viz., (i) pilot testing during 1992 to 1995, (ii) mainstreaming during 1996 to 1998 and (iii) expansion from 1998 onwards. The cumulative number of SHGs 'credit-linked' to the banks showed a significant expansion from 255 as at end-March 1993 to 16.18 lakh as at end-March 2005. Commensurate with an increase in the cumulative refinance support from NABARD from about Rs.0.3 crore as at end-March 1993 to over Rs.3,092 crore as at end-March 2005, the cumulative bank loans disbursed witnessed a sharp increase from about Rs.0.3 crore to around Rs.6,898 core during the period. This translates to an estimated 2.42 core poor families being brought within the fold of banking services. The loans per SHG increased to Rs.42,620 during 2004-05 from an average of Rs. 36,179 in the previous year, reflecting the process of deepening of the credit access amongst the SHGs.

New Paradigm

It is clear that the dominant theme so far has been of extending micro-credit through Bank-SHG linkages, with NABARD playing a leadership role and micro-finance institutions, mainly NGOs, playing a catalytic as well as enabling role at the gross root level. However, there is clearly an emerging new paradigm in the approach to micro-finance. It would be appropriate to recall that while the term micro-credit has not been strictly defined at present, it usually refers to the credits of "very small amounts". However, for the purpose of exempting the micro-finance companies registered under Section 25 of the Companies Act from the core regulatory provisions attracted by NBFCs, such companies are required by RBI to be engaged solely in extending micro-finance upto Rs.50,000 for small businesses and upto Rs.1.25 lakh for housing in rural areas. The term “micro-finance” has been given a working definition by the Task Force on Supportive Policy and Regulatory Framework for Micro-Finance set up by NABARD in November 1998 as: “provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards”. It is, however, understood that the MFIs provide other non-credit services as well such as capacity building, training, marketing of the products of the SHGs, micro-insurance, etc. In this background, the following considerations are relevant:

First, micro-finance would be seen to be a broader concept than micro-credit and the focus of discussion has now expanded beyond micro-credit to cover micro-finance.

Second, there is a recognition in the Annual Policy Statement of the RBI for 2005-06 of the need for enhancing financial inclusion and the banks were urged to review their existing practices to align them with the objective of financial inclusion in regard to banking services. This underlines the importance of the micro-finance movement in addressing the issue of financial exclusion.

Third, the increasing size and growth of MFIs seem to warrant a clearer policy framework to cover operations in financial services in addition to credit, in respect of both bank- and NABARD-led micro-finance through SHGs and micro-finance institutions.

Fourth, the delivery of non-credit financial services, such as insurance and mutual funds by micro finance institutions seems to be possible but as a pre-condition, there is a need for a clear framework for the approach of different regulators to these non-bank financial services by MFIs.

Fifth, the organisational forms of micro-finance institutions appear varied, though the activities may in some cases include non-financial services. This makes them subject to differing legal frameworks as per the organisational form.

Sixth, different State Governments take varying approaches to the microfinance institutions – including subsidising interest rates. The nature and spread of micro-finance movement also differ significantly across States.

Seventh, as per information available, a significant part of the current microfinance activity is related to credit, which is perhaps attributable to both the felt credit needs and the absence of a conscious policy thrust in regard to non-credit related financial services.

Eighth, developments in technology seem to provide a window of opportunity to reduce the transaction costs and thus enable microfinance to be commercially viable and profitable activity.

Finally, the Finance Minister in his Budget Speech for 2005-06 made a reference to the possibility of a suitable legislation in this regard.

Let me outline a preliminary response to these developments which, as will be described later, is being revisited by us. Broadly, the approach of RBI has been to emphasise the informality of micro-finance and focus on the developmental aspects. The regulatory dispensation put in place by the RBI seeks to enable enhanced credit flow from banks through MFIs and could be further refined by RBI, as necessary. On the suggestion for bringing the micro-finance entities under a system of regulation through a separate legislation, the RBI felt that microfinance movement across the country involving common people has benefited immensely by its informality and flexibility. Hence, their organisation, structure and methods of working should be simple and any regulation will be inconsistent with the core-spirit of the movement. It was also felt that ideally, the NABARD or the banks should devise appropriate safeguards locally in their relationship with the MFIs, taking into account different organisational forms of such entities. In any case, if any statute for regulation of MFIs is contemplated, it may be at the State-level with no involvement of the RBI as a banking regulator or for extending deposit-insurance.

Issues and next steps

In view of the new paradigm that was noticed in regard to microfinance, the RBI decided to revisit the issue in a comprehensive manner. Accordingly, several initiatives were taken in the recent months. First, consultations were arranged with several representatives of microfinance institutions in select centres to obtain their views. Second, based on such consultations, a Technical Paper on Policy relating to Development, Regulation and Supervision of Microfinance Services was prepared and was discussed with the representatives of this sector on July 18, 2005. The recommendations of the Paper are being considered in consultation with the Government. Third, and in parallel, an internal group of RBI on Rural Credit and Micro-Finance (Khan Committee) had been set up to examine the issues relating to this sector and the draft report of the Group was placed in the public domain on June 1, 2005 for comments. The report captures experience of other countries and our requirements both in terms of development of micro-finance and of financial inclusion. The final version of the Khan Committee report dated July 19, 2005 has since been placed on the website of the RBI. The report considers (a) policy options and strategies for deepening and widening of financial services; (b) promotion, development and rating of microfinance institutions and other outreach entities; and (c) regulatory issues and concerns. The Report will form a basis for evolving a policy framework in consultation with the Government, NABARD and other stake-holders.

It is, however, necessary to recognise that there are several issues which have to be clarified as one proceeds with a response, to what may be termed as, the new paradigm in micro-finance, described above. Importantly, the new paradigm seems to imply a process of formalising what has essentially been an informal mechanism of credit-disbursal, occasionally coupled with other activities, and expanding its scope. It is worth recounting some of the major issues in this regard.

First, how do we distinguish micro-finance institution from micro-credit institution and both these from other financial institutions? Is it by the ceilings imposed on the size of deposits, lendings and / or by defining activities? What part or percentage of the activity could be non-financial while the institution continues to be an MFI? Is there merit in differentiating between not-for-profit MFIs and the profit-seeking ones ?

Second, how do we identify, for regulatory purposes micro-credit institutions as distinct from micro-finance institutions since the latter may need more varied skills and in any case, warrant a policy view by more than one financial sector regulator?

Third, should the SHGs, which have no formal organisational structure, be brought within the ambit of the proposed formal framework for the MFIs?

Fourth, currently there are five organisational forms of the MFIs, viz., Trusts; Societies; Cooperative Societies; Not-for-Profit Companies and Non-Banking Finance Companies. There are also instances of large corporates undertaking micro-credit activity as a part of their operations. What are the merits and demerits of recognising one or more or all the organisational forms under a formalised regulatory framework for the MFIs?

Fifth, there is also a need to recognise the large regional differences in the spread of SHGs and the MFIs across the country. While the issue needs deeper analysis to identify the reasons for such variation and to promote balanced growth of the MFIs, it, *prima facie*, appears that the MFIs have flourished more in the States with well developed banking infrastructure and outreach. Thus, the MFIs in our country would seem to be a supplement rather than a substitute for a developed banking infrastructure.

Sixth, what should be the role of the foreign capital and venture capital in regard to the MFIs? It may be necessary to recognise here the orientation of the micro-finance activity given the limitation of size and skills in the MFIs and then consistency with the risk-reward bias of such sources of commercial capital. As regards the external commercial borrowings, the imperatives of exchange rate risk and the capacity of the MFIs to effectively assess and manage this risk would also need to be duly reckoned.

Seventh, what could be the scope and effectiveness of a self regulatory organisation for the MFIs and how it dove-tails with the possible formalised regulatory framework under contemplation?

Eight, the credit rating is usually assigned for specific instruments issued or for a defined purpose and often, on a continuing basis. There is merit in devising rating system for the MFIs, recognising that such exercises are seldom for localised views amongst decentralised entities. It will be instructive to review our experience so far in regard to utility and quality of rating exercises of MFIs. How to ensure that the rating exercise adds value to the localised operations of the MFIs?

Ninth, what are the prospects for expanding the permission accorded by the RBI to the non-banking financial companies for offering credit and other financial services to not-for-profit companies? What are the prospects for creating a separate category of NBFC-MFIs to be regulated by RBI?

Finally, should all the MFIs or only a select category out of them be permitted to accept public deposits? While there is a view that only banks should be permitted to accept public deposits, currently non-banking financial companies are also permitted to accept public deposits but subject to the regulatory prescriptions of the RBI. Needless to say, it is the issue of accepting public deposits that poses major challenges, both legislative and more importantly, of moral hazard.

As the experience with cooperative banking shows, a soft regulatory regime relative to scheduled commercial banks, be it in terms of governance or prudential aspects, trends to attract less than truly ‘fit and proper’ persons to capture such institutions. Indeed it is possible to argue that our experience with bringing cooperative banks under the Banking Regulation Act, 1949 in 1966 coupled with their coverage under Deposit Insurance, compared with the health and reach of the cooperative sector before such regulation came into effect, would provide some lessons in this regard. In fact, RBI in its comments on the draft report of the Task Force on Revival of Cooperative Credit Institutions (Vaidyanathan Committee, February 2005) argued in favour of substituting RBI’s regulatory jurisdiction with a separate independent national or State level regulatory, body broadly in line with what was advocated by Dr. Bimal Jalan in his policy statement in 2001 in regard to Urban Cooperative Banks. Currently, it is proposed to examine the issue in detail in the light of recommendations of the Khan Committee and keeping in view the Microfinance Consensus Guidelines issued in July 2003 by the Consultative Group to Assist the Poor (CGAP) incorporating the Guiding Principles on Regulation and Supervision of the MFIs. These Guiding Principles bring out globally recommended principles on regulation and supervision of micro-finance and they need to be considered in the context of conditions in our country.

There are several operational issues which could be addressed through coordinated efforts of the central government, State governments, regulators, banks and the NABARD. RBI has an interest in pursuing the subject as part of its thrust towards financial inclusion. As the micro-credit approach yields place to a more encompassing micro-finance approach, coordinating mechanisms amongst financial sector regulators and institutional regulators have to be considered. A view needs to be taken on permitting scheduled commercial banks to participate in the equity of the MFIs. There may also be a need for establishing processes for transition from one form of organisation to another, while remaining engaged in the micro finance activity. There are several tax measures, both at Central and State levels, from which MFIs have been seeking special dispensation but a view is yet to be taken on many of them. Training and capacity building is an area of high priority which, coupled with widespread use of technology, could reduce transaction costs and improve overall effectiveness while imparting robustness to the movement. Some States like Andhra Pradesh intend providing financial support for these purposes. There is considerable scope for increasing the tried and successful model of Bank-SHG linkages, especially to large tracts in the country which have not been adequately covered. RBI is currently engaged in exploring a forum where these issues could be addressed on a continuing basis, through a participative and consultative process amongst all the stakeholders.

In conclusion, it is necessary to recognise that we, in India, have to focus on extending financial services in both rural and urban areas for ensuring financial inclusion of all segments of the population. At the same time, one should avoid the temptation of creating one set of banking and financial institutions to cater to the poor or the unorganised, and another for the rest. The medium to long-term objective should be to ensure inclusion of all segments in the main-stream institutions while taking advantage of the flexibility of multiplicity of models of delivering a wide range of financial services. In this light, a comprehensive framework to revive the cooperative credit system, revitalise the Regional Rural Banks and reorient commercial banking system needs to get a high priority while simultaneously encouraging and enabling the growth of micro-finance movement in India, which has been very successful. We need to build on its strengths and extend it to vast areas which are inadequately covered by both banking and micro-credit entities. Micro-finance, broadly defined, needs to be explored in the light of the new paradigm described. RBI and NABARD recognise the growing importance of micro-finance and are committed to enable its healthy growth. However, several issues, both in regard to regulation as well as development of the MFIs need to be considered and must be comprehensively addressed. While the report of the Khan Committee would provide a good starting point for taking a view on developmental aspects, in particular, the CGAP’s Guiding Principles on Regulation and Supervision on Micro-finance provide a valuable and globally relevant framework in regard to the regulatory issues. The proposed forum for a consultative process on the MFIs would also be useful in evolving an appropriate framework for development of the MFI sector. No doubt, a very well-crafted balance between the regulation and growth objectives would be warranted in formulating our approach to a regulatory regime, keeping in view the big challenge of financial inclusion of a large segment of the Indian population. Thank you.