Anand Sinha: Strengthening governance in Microfinance Institutions (MFIs) – some random thoughts

Keynote address by Mr Anand Sinha, Deputy Governor of the Reserve Bank of India, at the Federation of Indian Chambers of Commerce and Industry's (FICCI) workshop on "Strengthening Microfinance Institutions (MFIs) – good governance and strategic people practices", Mumbai, 23 April 2012.

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Thank you for inviting me to deliver the keynote address at this microfinance workshop. Microfinance is currently at the centre of intense policy debate, especially, in the context of governance and regulatory oversight related issues. The current workshop which focuses the deliberations on governance issues in microfinance is, therefore, quite timely as well as contextually relevant. I congratulate the organisers on their choice of subject for this workshop and hope that the deliberations will help all of us in going forward.

Microfinance, involving extension of small loans and other financial services to low income groups, is a very important economic conduit designed to facilitate financial inclusion and assist the poor to work their way out of poverty. It has the potential to fill the critical gap left by formal financial institutions in providing financial services to low income groups. Mainstream institutions shied away from providing financial services to the poor considering them unviable owing to high costs involved in reaching out to the unbanked/under banked areas where there is not enough scale of operations due to low numbers and low value of transactions. Other reasons cited for such exclusion are, perceived high risk and inability of poor borrowers to provide physical collateral for raising loans.

Microfinance became a leading and effective strategy for poverty alleviation with the potential for far-reaching impact in transforming the lives of poor people. It is argued that microfinance can facilitate the achievement of the Millennium Development Goals (MDGs) as well as national policies that target poverty reduction, empowerment of women, assisting vulnerable groups, and improving standards of living. As pointed out by the former UN Secretary General Kofi Annan during the launch of the International Year of Micro Credit (2005):

> "sustainable access to microfinance helps alleviate poverty by generating income, creating jobs, allowing children to go to school, enabling families to obtain health care, and empowering people to make the choices that best serve their needs".

Although microfinance cannot be seen as a panacea for poverty reduction, when properly harnessed, it can make sustainable contributions through financial investment leading to the empowerment of people, which in turn promotes confidence and self-esteem, particularly for women. More importantly, the global experience with microfinance has shown that even poor are creditworthy.

Studies have shown that microfinance plays three critical roles in development. Firstly, it enables the very poor households to meet their most basic needs and protect/hedge against risks. Secondly, concomitantly it is associated with improvements in households' economic welfare. Thirdly, by supporting women's economic participation it helps to empower women and promote gender equity.

I. Microfinance and India

Inclusive growth always received special emphasis in the Indian policy making. Government of India and the Reserve Bank of India have taken several initiatives to expand access to financial systems to the poor. Some of the salient measures are nationalisation of banks, prescription of priority sector lending, differential interest rate schemes for the weaker sections, development of credit institutions such as Regional Rural Banks, etc.

Despite the policy efforts, gap remains in the availability of financial services in rural areas. The dependence of the rural poor on money lenders continues, especially for meeting emergent requirements. Such dependence is more pronounced in the case of marginal farmers, agricultural labourers, petty traders and rural artisans belonging to socially and economically backward classes and tribes whose capacity to save is too small.

It is in this backdrop that microfinance emerged in India. The Self-Help Group (SHG)-Bank Linkage Program (SBLP) which was launched in 1992 on a pilot basis soon grew significantly. As per the latest estimates, SHGs enable 97 million poor households' access to sustainable financial services from the banking system and have an outstanding institutional credit exceeding Rs. 31,200 crore as at the end March 2011. SBLP is considered to be the fastest growing microfinance initiative in the world. The other model of microfinance, i.e. MFI model comprising of various entities, such as, non-banking financial companies (NBFCs), non-governmental organisations (NGOs), trusts, cooperatives, etc. has also been growing significantly in the recent years.

Microfinance- both SBLP and the MFI sector- has posted an impressive growth in the past few years with the combined client outreach increasing from about 4.8 crore[1] in 2006–07 to 8.6 crore in 2009–10. Loans outstanding to SHGs were Rs. 28,038 crore while loans disbursed to MFIs by all agencies amounted to Rs. 13, 955 crore at the end March 2010.

II. Recent developments in microfinance sector

There has, however, been a sudden downturn in the prospects of the sector in the second half of 2010-11 owing to reported excesses of some MFI institutions and the consequent legislative response by a state government. On the back of these developments, the MFI segment has taken a severe beating with rising delinquency ratios and downgrades by rating agencies. Lenders have turned wary leading to drying up of funding channels seriously impinging on the business. It is reported that disbursements by MFIs in Andhra Pradesh plummeted significantly in the second half of 2010–11. The recovery rates that were 99 per cent reportedly fell to a meagre 10 per cent, leading to huge NPAs which is causing significant stress on the functioning of MFIs. While the loans given to MFIs during 2010–11 declined to Rs. 8448.96 crore from Rs. 10,728.50 crore in 2009–10, the amount of outstanding loans reduced from Rs. 13,955. 75 crore in 2009–10 to Rs. 13,730.62 crore in 2010–11.

Many analysts attribute the current crisis to the irrational exuberance of some MFIs who entered the segment with the sole emphasis on business growth and bottom lines. They perhaps did not take due cognisance of the vulnerability of the borrowers and the potential socio-political ramifications their aggressive approach could possibly lead to. The competition among MFIs led to these institutions chasing the same set of borrowers, by free riding on SHGs and loading them with loans that borrowers, possibly, could not afford. It is reported that as at the end of March 2010, the number of loan accounts per poor household in Andhra Pradesh was on an average more than 10. In their eagerness to grow business, the institutions had given a go by to the conventional wisdom and good practices such as due

[1] 1 crore = 10 millions

diligence in lending and ethical recovery practices. Over-indebtedness of the borrowers led to difficulties in repayments and the forced recoveries by some MFIs led to public uproar and the subsequent intervention by the state government.

The legislation enacted by the Andhra Pradesh Government has brought the customer protection issues to the centre stage. The legislation stipulated mandatory registration of MFIs, disclosure of effective interest rate to the borrowers, ceilings on the interest rates and strict penalties for coercive recovery practices. One of the fall outs of these developments has been the severe dent in the MFI business due to dwindling resources.

Reserve Bank constituted a Committee (Chairman: Shri Y H Malegam) to study issues and concerns in the MFI sector. The Committee examined the issues and made recommendations to address the present concerns. Some of the significant recommendations are as under:

i. creation of a separate category of NBFCs operating in the microfinance sector to be designated as NBFC-MFIs.

ii. imposition of a margin cap and interest rate cap on individual loans;

iii. requirement of transparency in interest charges;

iv. lending by not more than two MFIs to individual borrowers;

v. creation of one or more credit information bureaus;

vi. establishment of a proper system of grievance redressal procedure by MFIs;

vii. creation of one or more “social capital funds”;

viii. continuation of categorisation of bank loans to MFIs, complying with the regulation laid down for NBFC-MFIs, under the priority sector, etc.

The recommendations of the Committee have brought out clarity in regulation of MFIs and led to the containment of the crisis without domino effect. Based on the recommendations of the Malegam Committee, the Reserve Bank of India has issued detailed guidelines permitting categorisation as priority sector advance, of bank credit to certain eligible MFIs. Such eligibility is linked to core features of microfinance, such as, lending of small amounts to borrowers belonging to low income groups, without collaterals, with flexible repayment schedules and with particular emphasis on measures to curb over-indebtedness. Margin caps and interest rate caps have also been stipulated to ensure protection of borrowers. Subsequently, the Reserve Bank of India created a separate category of NBFCs dealing in microfinance – NBFC-MFI and issued comprehensive guidelines covering, inter alia, fair practices in lending such as transparency in interest rates, non-coercive methods of recovery, measures to contain multiple lending and over-indebtedness.

Government of India has come out with *The Microfinance Institutions (Development and Regulation) Bill, 2011* which, among other things, envisages the Reserve Bank of India as the sole regulator of microfinance sector covering all forms of MFIs in addition to NBFC – MFIs which are presently being regulated by the Reserve Bank. The Bill has been circulated among various stakeholders for their views.

III. Key lessons and the way forward

Having briefly covered the background to the current state of affairs let me now focus on some of the specific issues that need to be examined to address the current impasse. While a number of reasons have been attributed for the turmoil in the sector, such as, unjustified high rates of interest, lack of transparency in interest rate and other charges, multiple lending and over-borrowing, coercive methods of recovery, etc. I would consider the governance deficit coupled with people risk, process risk and relationship risk as the more critical factors that have precipitated the turmoil and need to be addressed. MFIs need to seriously examine their governance systems and align their practices with the overall objective of microfinance which is to facilitate financial inclusion and empower poor.

Governance in MFIs

Governance, as we all know, is essentially about doing business and maximizing shareholders' wealth legally, ethically and on a sustainable basis. Being fair and to be seen as being fair to all the stakeholders without discrimination or bias, is the test for good governance. Governance system represents the value framework, the ethical framework, the moral framework as also the legal framework under which business decisions are taken. Governance would encompass self regulation both at the individual entity level and at industry level through the SRO mechanism. These two would form the first line of defence with the regulatory framework providing the backstop. In the absence of effective self regulation, the regulatory framework becomes more prescriptive which raises costs to regulators and supervisors in administering the regulatory framework and also increases compliance costs to the regulated entities. This clearly is a suboptimal solution. The considerable intellectual appeal of *principles based* regulation which had committed proponents is a case in point. In the wake of the subprime crisis of 2008, it has yielded considerable ground to the proponents of *rules based* regulation. Let me clarify that *principles based* regulations and *rules based* regulations are not binary choices. What distinguishes them is the less or more prescriptive regulations.

Governance is based on the basic tenets of transparency and accountability. Transparency in decision-making provides comfort to all stake holders and accountability which follows from transparency fixes responsibilities for actions taken or not taken. Together they safeguard the interests of the stakeholders in the organisation.

There were serious deficiencies observed in the governance framework of some of the MFIs. The corporate governance issues in the MFI sector were exacerbated by some of the "*for profit*" MFIs, dominated and controlled by promoter shareholders which led to inadequate internal checks and balances over executive decision making and conflict of interests at various levels. Other undesirable practices such as connected lending, excessively generous compensation practices for senior management, founders/ directors and failure of internal controls leading to frauds precipitated the crisis. Some of the MFIs chased high growth trajectory at the expense of corporate best practices. The listing and trading of the shares of the "*for profit*" MFIs generated a set of incentives which attracted capital looking for high returns whereas the capital suited for catering to the needs of the poor has to be patient capital. This disconnect led to further worsening of the situation. What is more disturbing is that there were enough warning signals of trouble in making over an extended period of time but the MFIs, at least some of them, carried away by their immediate success, failed to pay heed. These events have been narrated by Dr. Y V Reddy, former Governor, Reserve Bank of India in an article titled "*Microfinance Industry in India: Some thoughts*" in Economic and Political Weekly (EPW) (October 8, 2011). Relating the events in Andhra Pradesh, he has stated that Government of Andhra Pradesh always had discomfort with the NBFC-MFIs and every effort was made by the Reserve Bank of India to introduce a voluntary code of conduct. Resolution in this regard was thought to have been achieved in 2007. In retrospect, Dr. Reddy says that perhaps the trust that Reserve Bank placed in the commitment of MFIs was misplaced and, given the track record, the Reserve Bank should have insisted on enforceable regulation and not been content with an advisory role. Dr. Reddy's observations lead to another very important tenet of corporate governance i.e. the need to pay attention to the feedback loops, particularly the negative feedback loops and to take mid-course corrective actions. Those who fail to do so, end up paying a heavy price.

Inclusive finance vs. regulations[2]

History is replete with examples that good intentions may not always lead to good outcomes. Intentions need to be adequately backed by sound framework of governance and regulation. This is demonstrated by the experience of sub-prime housing loans in US and microfinance in India. When private sector emerged in microfinance, regulation responded positively by providing a supportive enabling environment: (a) lending by banks to MFIs for on lending was deemed priority sector; (b) banks were advised to lend to MFIs without a cap on interest rates and (c) group guarantees were deemed as collateral for the purposes of asset classification, prudential and provisioning norms. MFIs were expected to be carrying forward the agenda of inclusion, and were fully aligned with the banking system. MFIs, however, enamoured by the fast growth and expanding balance sheets, shifted goals, strategies and practices. Dr. Reddy has observed in the same article that the assumption that the people working in MFIs were committed to a value framework that aims at profit-making but not profiteering or profit maximization, was not validated, going by the organisational structures and incentive frameworks as well as the lifestyles of senior managers.

The MFI episode in India has, at least, two close parallels with the subprime crisis of 2008. First, the origin of the subprime crisis was about extending loans well beyond the borrowers' capacity to pay and second, compensation practices were a major contributing factor to the crisis as these practices were designed to enhance risk taking and create value for share holders but not to protect other stakeholders. Corrective actions are being taken in the context of regulatory reforms for banks thorough, Basel III guidelines and for MFIs through guidelines based on the Malegam Committee recommendations.

Learning from the crisis, we need to build a regulatory framework which ensures a balance between flexibility to MFIs in their operations and regulations that ensure customer protection and financial health of the MFIs. In the long run, MFIs also will be benefited by such regulatory framework as it enables orderly growth and reduces uncertainty. The envisaged regulatory framework must put in place restrictions and safeguards with regard to minimum standards of governance, management and customer protection as well as the financial health of MFIs. Naturally, robust regulations coupled with thorough risk based onsite and offsite supervision are needed to foster entrepreneurship while encouraging inclusive and sustainable economic growth, especially with reference to end users. This balance would be provided by the regulatory framework derived from the Malegam Committee Report and the SRO framework.

Balancing the dual objectives – social and financial

There is no denying the fact that self sufficiency and financial sustainability are the objectives that MFI could pursue. However, in the race to earn profits, the social objective should not be lost sight of. Mission drift, where the institution deviates from its original mission in pursuit of a conflicting unannounced mission, is a major risk the MFIs face. The Boards of MFIs will have to balance the objectives of various stakeholders, viz., the equity holders, the donors, the borrowers and the overall society. Strong corporate governance could play a critical role in balancing seemingly exclusive but potentially complimentary objectives from a long term perspective.

The question of balance between profits and serving the financial services needs of the poor is certainly an issue for MFIs. It is often asked that if the MFIs moderate their pace of growth and shift their priorities more towards social objectives, would they be able to attract enough investors to provide capital to enable the MFIs to take their activities designed to help the poor forward. Similar questions have arisen in the context of substantially enhanced

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[2] BIS Paper No. 62, January 2012

regulatory framework for banks under Basel III, in particular the much higher capital and liquidity requirements. There is an apprehension that with much larger capital and liquidity requirements under Basel III to support similar level of activities, the Return on Equity (RoE) would go down appreciably and consequently banks may not be able to attract investors to provide capital. This line of thinking disregards the risk-return trade-off and the fact that banks can raise their productivity and efficiency levels to protect their ROEs, at least partially. It is hoped that when investors see a much more stable and safer banking system they would be willing to supply capital at lower returns. Similarly, MFIs, which align their business objectives with the requirements of the social segment they cater to, would be seen as stable and less risky and would certainly prove attractive to the investors than the ones that provide extraordinary but unstable returns. In this context, I would like to draw your attention to Malegam Committee's recommendation of "creation of one or more domestic social capital funds".

Customer protection and responsible finance

Responsible finance is the most important lesson from the current episode. Given the vulnerability of their customers, MFIs need to be more mindful of their needs and capabilities. Chasing customers and sometimes, as it is alleged, poaching them from other segments of microfinance and loading with more debt would lead to issues such as wrong selection of borrowers, over-indebtedness and eventually to delinquencies.

MFIs, therefore, need to revisit their business model and ensure more responsible financing. This would require them to adopt approaches to select their borrowers with diligence, ensure that their lending is not leading to over-indebtedness and be more human and ethical in their recovery methods.

Building enabling organisational climate

There is a strong need to build good practices within the institutions and encourage organisational culture which values customer protection and well being. The frontline staff need to be educated about the organisational values and social mission so as not to get swayed by the short term performance targets. Further, the organisational culture should nurture values like honesty, respect, transparency etc.

Self regulation

Events in the last few years have indicated that the "*for profit*" model of microfinance, where there is a heightened emphasis on rapid scale and high profitability, has not been very successful in meeting their social objectives nor has such a model been sustainable. While regulatory responses are being put in place to address the current impasse, a degree of self-regulation is a must in building robust and efficient microfinance institutions going forward. Self regulation would require putting in place a code of conduct that would allow for a reputation-building mechanism and adherence to best governance practices.

Transparency

With the customer base being largely from the low-income group whose financial knowledge and sophistication cannot be taken for granted, it is incumbent upon the MFIs to be transparent about the interest charged and the total cost to be borne by the customers. It was reported that some MFIs not only charged excessive interest, but had also loaded many other components to the overall cost. MFIs need to remind themselves, that while dealing with vulnerable sections of the society, the argument of "*caveat emptor*" does not always hold good.

Credit information

Absence of comprehensive credit information has been a handicap in the development of the sector. The multiplicity of financing institutions acting independently increases the level of information asymmetry among them, which may lead to delays in sanction, double financing, etc. The building up, and sharing, of credit information will help in enhancing synergies among the various institutions and also ensure avoidance of multiple financing and consequent over-indebtedness. In this context, let me add that as per Credit Information Companies (Regulation) Act, 2005, NBFCs, as credit institutions, are required to be members of at least one Credit Information Company (CIC) (currently there are four CICs). What is important is that credit data regarding all the borrowers should be furnished to the concerned CIC accurately and timely and full use should be made of the database of CICs while extending credit, to guard against adverse selection and over indebtedness.

Diversification

It was observed that MFIs found a few geographies more profitable than others and against conventional wisdom which advocates diversification, ran in droves to the same geographies with southern region showing significant concentration of SHGs and MFIs. Excessive proliferation of entities in a few regions, led to immense, and, sometimes, unhealthy competition leading to perverse practices. It is now comforting to see that, learning from the recent episode, the MFIs are reorganising themselves and are spreading into, hitherto, untapped regions. Diversification helps not only MFIs in withstanding any region specific shocks but also help customers at large, by spreading the microfinance across the country.

Improvising the business model – reducing costs

Microfinance is a labour intensive sector involving significant delivery costs. While the entities could build these costs into their services and charge the customer, which many in fact did, the more efficient way of protecting or increasing one's margins is reducing the operational costs by enhancing efficiency and leveraging technology. MFIs should not pass on their operational inefficiencies to clients in the form of prices that are far higher than they need to be. Considering the profile of the borrowers who are poor, to whom even a small increase in rates could make a lot of difference, MFIs should strive to build more cost effective and efficient delivery models to serve their clientele better.

Credit rating of MFIs

The rating of MFIs assumes critical importance as MFIs are sourcing financing from banks and other institutions. There are several MFIs in the country and their rating helps the lenders to choose the right one. Further, such positive discrimination helps the better managed MFIs in reducing their borrowing costs and also acts as a dis-incentivising factor for not so well managed ones.

Moving beyond finance

The poorest sections of the poor require considerable handholding in terms of input supply, training, technical support, market linkages, etc. The formation and nurturing of such groups require not only providing of financial services but also institutional development services, all of which would require a greater role for the MFIs. In order to achieve its full potential in empowering the poor, microfinance should become an integral part of the financial sector and MFIs need to play a larger developmental role.

IV. Summing up

At a time when financial inclusion is at the center stage of the regulatory landscape, the last mile connectivity provided by the MFIs has to be leveraged upon, to include the hitherto financially excluded. Although the MFIs are facing tough times, there is a fair degree of opportunity to build long-term sustainable business around microfinance. Balancing the interests of the vulnerable borrowers as also the microfinance institutions; effective regulations, well calibrated transition time and some breathing space to the institutions could help the microfinance sector to turn around, expand and help achieve inclusive growth.

The recent episodes in the MFI sector have raised certain serious concerns on the governance issues. MFIs should identify their unique role in the financial system and should put in place robust governance standards to balance the dual objectives of social utility and financial sustainability.

I am sanguine that the Workshop would deliberate extensively on the issues. I wish the workshop all success.

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