Financial Inclusion – Indian Experience
by M R Umarji

Promotion of financial inclusion involves extending services of collection of thrift, grant of micro credit and facilities for remittance of funds. The major issue involved in the problem of financial exclusion is extending credit to the poor people who do not have access to financial services and are dependent on moneylenders. Credit extended by moneylenders has earned a bad name on account of usury and strong-arm methods for recovery, used by moneylenders. Money lending activity has evoked comments such as "Private Control of Credit is modern form of slavery[1]"; or "Debt is the slavery of the free[2]" or "Debt is the worst poverty[3]". Replacement of money lending system by providing access to the well regulated banking services is an area of concern which is being addressed by all the emerging economies. It is true that tackling financial exclusion is essentially a domestic problem for the respective States to address and one may question whether there is a need for an International Organisation like UNCITRAL to undertake any project on such domestic issue. But the problem is universal and most of the States are struggling to find an appropriate regulatory framework to promote financial inclusion through the Micro Finance Institutions. Hence, it would be worthwhile for UNCITRAL to ascertain various measures adopted by member countries, evolve standards and best practices based on success stories, for regulation and development of Micro Finance Institutions (MFIs).

Collection of Small Savings/Thrift by MFIs

Collection of small savings of poor people who do not have access to a bank account is one major challenge in promoting financial inclusion. Micro Finance Institutions can be allowed to collect such savings but there is a danger of unscrupulous elements entering the market and collect funds and disappear from the scene. MFIs cannot be allowed to accept small savings unless they are brought within the regulatory purview of the Central Bank or any other Regulator otherwise there is

[1] Upton Sinclair
[2] Publilius Syrus
[3] Thomas Fullar

risk of shaking the faith and trust of the poor people in the Micro Finance Institutions. Regulation of MFIs is a challenge on account of following reasons:

- Most of the MFIs have a non-corporate structure such as societies, trusts, religious or charitable trusts;
- Such MFIs do not have adequate capital and reserves and ability to raise capital on account of non-corporate structure;
- Management of MFIs have very limited exposure to managing financial business.

Normally Regulators are insisting that entities undertaking financial business should have certain minimum capital and specified percentage of deposits collected shall be invested in Government securities and certain minimum cash reserve is maintained with the Central Bank. Unless such depositor protection measures are taken no entity can collect deposits from the public. In India the Reserve Bank recognises Non-Banking Finance Companies and subject to compliance with regulatory norms, such NBFCs are permitted to collect deposits. The extent of deposit liabilities that can be undertaken by the NBFCs is also prescribed by the RBI and there is a continuous on-going supervision of such companies by RBI. Such MFIs are treated as on par with banks and regulated accordingly.

But the non-corporate MFIs are operating in the Micro Finance Sector and such entities are not permitted to collect thrift from the people. They are permitted to undertake only lending activity and sources of finance for such entities are borrowing from banks and raising funds from investors. In the process the poor persons facing financial exclusion are denied the facilities to deposit their savings in any bank or other organization, which assures safety of the funds deposited. In India this difficulty is addressed by directing the banks to introduce Business Correspondents Scheme under which MFIs or any other business organizations operating in rural areas are appointed as a correspondent of the bank and they accept thrift from the poor persons resident in the area. Such Business Correspondents act for and on behalf of the banks and are accountable to the banks.

Lending activity of MFIs

MFIs are mainly engaged in lending activity and depend on borrowings and investment as sources for funds for lending. Since such funds have high cost, the interest rates on loans given to poor are also on higher side. This raises a regulatory issue whether interest rates to be charged by MFIs should be free and left to market forces or prescribed by the Regulator. Challenges for regulation of lending activities by MFIs are:

- Regulation of interest rates
- Ensuring observance of Fair Debt Collection Practices by MFIs

In India Micro-finance has been important component of the financial inclusion process. The Self-Help Group-Bank Linkage Programme (SBLP), which started as a pilot programme in 1992 has developed with rapid strides over the years. In 2009-10, 1.59 million new SHGs were credit-linked with banks, and bank loan of < 14.4530 million (including repeat loan) was disbursed to these SHGs. Further, at end-March 2010, 6.95 million SHGs maintained savings accounts with banks (Table IV.35). On an average, the amount of savings per SHG was < 8,915 as compared to the amount of credit outstanding of <57,795 in 2009-10. While there was a continued increase in the amount of credit outstanding per SHG, there was a fluctuating trend in the amount of saving per SHG in the recent years.

Table IV.35: Progress of Micro-finance Programmes
(As at end-March)

Item	**Self-Help Groups**			
	Number (in million)		**Amount <crore)**	
	2008-09	**2009-10**	**2008-09**	**2009-10**
Loans disbursed by banks during the year	1.61 (0.26)	1.59 (0.27)	12,254 (2,015)	14,453 (2,198)

Loans outstanding with banks	4.22 (0.98	4.85 (1.25)	22,680 (5,862)	28,038 (6,251)
Savings with banks	6.12 (1.51)	6.95 (1.69)	5,546 (1,563)	6,199 (1,293)

Item	**Micro-Finance Institutions**			
	Number		**Amount ` crore)**	
	2008-09	**2009-10**	**2008-09**	**2009-10**
Loans disbursed by banks during the year	581	691	3,732	8,063
Loans outstanding with banks	1,915	1,513	5,009	10,148
Savings with banks	-	-	-	-

Note: 1) Figures in brackets indicate the details about SHGs covered under Swarnajayanti Gram Swarozgar Yojana (SGSY).

2) * : The actual number of MFIs provided with bank loans would be lower on account of MFIs availing loans from more than one bank.

Alongside SBLP, Micro-finance Institutions (MFIs), such as Non-Governmental Organisations (NGOs), NBFCs, among others, have emerged as important sources of micro-finance delivery in India. In 2009-10, 691 MFIs were provided loans by banks to the tune of `8,063 crore. The growth under the MFI-linkage programme in terms of both number of credit-linked institutions and amount of loans was much higher than the corresponding growth under the SHG-Bank Linkage Programme in 2009-10.[**]

Although the Reserve Bank of India has formulated scheme for lending to MFIs by Banks for on-lending to poor persons and also another scheme for lending to SGHs by Banks, Non-Corporate MFIs are not formally regulated by the RBI. Recently this has raised a policy issue as to whether such MFIs can be regulated by the State Governments under their respective money-lending laws or RBI is expected to regulate them.

[**] Source : RBI Report on Trend & Progress of Banking in India 2009-10, page 94.

On account of some MFIs adopting strong-arm tactics for recovery of loans in the State of Andhra Pradesh, the State has assumed regulatory powers and imposed number of restrictions on the operations of MFIs. The policy issue at national level is whether to treat micro finance activity as similar to banking or as money lending to be regulated by State laws applicable to moneylenders is yet to be resolved.

There is also a legislative proposal under consideration of the Central Government as the Micro Finance (Development & Regulation) Bill, in terms of which National Bank for Agriculture and Rural Development (NABARD) is to be entrusted with the function of regulating MFIs. Other salient features of the Bill are as under:

- MFI with certain minimum capital and complying with regulatory requirements will be required to obtain registration from the Regulator and shall be permitted to collect thrift from members of self-help groups;

- The Regulator can prescribe maximum amount of thrift that can be collected and other measures for protecting the interest of depositors;

- The Regulator shall also have powers of on-site and off-site inspection of MFIs and to issue directions from time to time;

- There will be a Micro-Finance Development and Regulation Council established with experts and other practitioners with hands-on experience in the MF sector shall be members of the Council;

- Parameters of various business activities that MFIs can undertake is to be laid down by the law;

- Caps on amounts of thrift that can be collected and the amount of loan that can be granted can be specified by the Regulator;

- The form of balance-sheet and financial statements to be maintained by MFIs and audit of their accounts can be prescribed by the Regulator.

Regulatory challenges

In conclusion regulatory challenges in promoting financial inclusion through the medium of MFIs are many and one easy solution is to set up a New Regulator to regulate activities of MFIs. But such new Regulator will involve huge recurring costs and hence there is a need to find alternative solutions. One option is to list out basic parameters on the structure, capital, management of MFIs and register the MFIs complying with such parameters and permit them to undertake thrift collection and lending activities. Other MFIs can be permitted to undertake lending activities subject to ensuring observance of fair debt collection practices, avoid excessive lending and be fair and reasonable in charging interest. Further MFIs who have raised funds from investors need to balance the expectations of investors for returns on their investments and the interest rates on the loans given to poor. Lending to poor is a sensitive issue and MFIs have to ensure that they are fair and reasonable in their dealings with the borrowers. In their zeal to increase the levels of interest income, MFIs need to remember that focus of lending to the poor is to enable them to raise income levels and improve their living standards and the object is not to enhance the rate of return on the capital. Moderation in fixing interest rates and promising returns on investment would be in the interest of all stake holders and would facilitate growth of MFIs and promotion of financial inclusion.

[the author is Chief Adviser Legal India Banks Association.
The views expressed in this paper are personal]