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‘I’ve always been proud to say I’m doing microfinance. In the early days, nobody knew what it was, and I was happy to explain what we were trying to do. Now when people ask, I feel embarrassed. And I feel like hiding somewhere. I often say, I must admit it, I’m just retired. So this is the sorry state of the sector today. So far we’ve fallen.’

(Gibbons, 2010)

‘Here, my feeling is, one of the reasons why consumer protection in microfinance has not been a priority, [...] there is an inherent contradiction, or a conflict of interest. A MFI can not grow, if they want to pay attention to the clients.’

(C.S. Reddy, p.c.)

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ABBREVIATIONS

AKMI	Association of Karnataka Microfinance Institutions
AP	Andhra Pradesh
APMAS	Andhra Pradesh Mahila Abhivruddhi Society
APPG	All- Party Parliamentary Group
BC	Business Correspondent
CGAP	Consultative Group to Assist the Poor
CMF	Centre for Microfinance
CMR	Centre for Microfinance Research
CoC	Code of Conduct
CPA	Consumer Protection Act
CSFI	Centre for the Study of Financial Innovation
CUVMF	Candid Unheard Voice of Indian Microfinance (Blog)
DFID	Department for International Development
ECLG	European Consumer Law Group
FWWB	Friends of Women's World Banking
GIZ	German Society for International Cooperation (Deutsche Gesellschaft für internationale Zusammenarbeit), previously GTZ (Gesellschaft für technische Zusammenarbeit)
GTZ	See GIZ
IFC	International Finance Corporation
IFMR	Institute for Financial Management and Research
IPO	Initial Public Offering
IRDA	Insurance Regulatory and Development Authority
JLG	Joint Liability Group
MAC	Mutually Aided Cooperative Society
M-CRIL	Micro-credit Ratings International Ltd.
MFDR	Microfinance Development and Regulation Authority
MFI	Microfinance Institution
MFIN	Microfinance Institutions Network
MIX	Microfinance Information Exchange
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non-Banking Financial Company
NCAER	National Council for Applied Economic Research
NGO	Non-governmental Organisation

NREGA	National Rural Employment Guarantee Act
NYT	The New York Times
p.c.	Personal communication
PAC	Primary Agricultural Credit Society
PAR	Portfolio at Risk
PMO	Peer Monitoring Organisation
PRADAN	Professional Assistance for Development Action
PRI	Principles for Responsible Investment
RBI	Reserve Bank of India
RRB	Regional Rural Bank
Rs.	Rupees
SDC	Swiss Development Council
SFA	Swadhaar FinAccess
SERP	Society for Elimination of Rural Poverty
SEWA	Self Employed Women's Association
SHG-BLP	Self-Help Group – Banking Linkage Programme
SHPI	Self-Help–Promoting–Institutions
SIDBI	Small Industries Development Bank of India
SRO	Self-Regulatory Organisation
SSR	State of the Sector Report
UNDP	United Nations Development Programme
UNICEF	United Nation International Children's Emergency Fund
USD	US Dollar
USIG	United States International Grantmaking

QUANTITATIVE UNITS AND EXCHANGE RATES.

1 LAKH	Rs.	100,000 Rs.	100 Rs	1.56 EURO
1 CRORE Rs		10,000,000 Rs.		2.2 USD
			(RATE OF 31.03.2011)	

PREFACE

Microfinance and Financial Inclusion have been under discussion as a means of empowerment and development aid for at least forty years. Since Muhammad Yunus and the Grameen Bank won the Nobel Peace Prize in 2006, interest in the matter has risen further.

The Nobel Committee described Microcredit as ‘an important liberating force in societies where women in particular have to struggle against repressive social and economic conditions’ (The Norwegian Nobel Committee, 2006). Microfinance seemed to present a silver bullet in development. It allegedly helps women out of poverty and empowers them to become entrepreneurs by providing access to financial products, thus providing opportunities to the poor to overcome poverty. At the same time it would achieve a stronger position of women, a stronger community, access to education for children, and with economic uprise, health parameters would improve.

The idea of a social business, which meets a double bottom line by being not only financially sustainable but also achieving social goals, was given a lot of attention, not only in the media, but also by equity investors. In India, more and more such institutions started operating. As they often considerably overlap in their focus, they have begun to compete for investors, staff and clients. In this competition for faster growth and attraction of equity investors, several organisations have overstressed economic success and lost track of their second mission: to help empower the poor. Against this background, three major delinquency crises occurred in the Indian microfinance market in the last years.

In these crises, Microfinance Institutions (MFIs) were accused of freely giving multiple loans and later harassing clients who were struggling to pay back (The New York Times, 2010). Quite suddenly, MFIs were hindered in continuing their operations by state or religious authorities and clients refused to pay their instalments. Soon, stories of farmers committing suicide because of over-indebtedness and coercive recovery practices by MFIs were reported (The Economist, 2010a). Many observers (e.g. The Wall Street Journal, 2009), compared the situation to the US subprime crisis: They described a bubble in microfinance, created by giving too much credit to people who were not creditworthy. It was argued that the situation of MF clients not only does not improve, but that they are actually worse off because of their loan. Others argued that attacking microfinance was merely a political coup in order to retain political power by gaining the votes of the poor (The Economic Times, 2010a). These issues

have dominated global news and public opinion on Indian microfinance in 2010 and 2011. Now, there is a climate of scepticism and disbelief against the ‘miracles of microfinance’.

The need for consumer protection in this field was not addressed for the longest time. Microfinance was solely perceived as an opportunity for clients, without taking eventual risks into account. That socially oriented institutions lead to over-indebted clients came as a surprise to many. This perception of the microfinance sector explains the lack of regulation of the sector.

Over the last years the issue of consumer protection has been discussed amongst all stakeholders – politicians, donors, investors, MFIs and their associations. Still, the adoption and implementation of consumer protection proves difficult. There is a consensus on the need to improve and strengthen consumer protection. What client protection in microfinance should entail seems to be undisputed, as various institutional codes converge on the same core principles. These codes usually prescribe transparent pricing, appropriate collection practices and ethical staff behaviour, avoidance of over-indebtedness and mechanisms for redress of grievances (see e.g. The Smart Campaign, 2010).

In 2010 and 2011 the Indian State of Andhra Pradesh (AP) and the Reserve Bank of India (RBI) adopted regulations for the microfinance sector. The central state issued a new draft for a central microfinance law in July 2011. Still, there is no unified regulation in India and it is likely that the introduction of these regulations will ensue lengthy constitutional conflicts over the competences of different government bodies. Besides, it is also unclear how regulations can be implemented and safeguarded in practice. The regulator can try to implement strict regulation, however, what happens in actuality can only be controlled to a limited extent. At the moment industry associations have good intentions, but not sufficient power to act against the interests of their members. If they do get strengthened, they could become very important watchdogs for the regulator. Lenders enjoyed growth without scrutinising the promises of MFIs, or were only interested in the financial aspects of lending from the start. MFIs have been infected by the race for maximum growth and focussed on financial data. This is partly due to the difficulty encountered with measuring social performance. At present, they are struggling to regain their credibility and funding, as banks and investors have stopped lending to them.

FOCUS AND OUTLINE

The main focus of this paper is the position of clients in Indian microfinance.

In all credit transactions there exists a difference in information between borrower and lender. The group lending methodology of microfinance was designed for lenders to overcome the lack of information about the risk-taking and creditworthiness of borrowers.

In my thesis I wanted to find out, if, at the same time, an informational asymmetry to the other side exists. This asymmetry, namely the lack of information of clients, which seems to occur in microfinance, lies at the heart of consumer protection issues in all fields. In the context of microfinance, it was so far largely ignored. This is probably due to seeing commercial microfinance as a development programme and not as a for-profit business.

Secondly, I was interested to find out how much importance is given to consumer protection in commercial microfinance and how microfinance insiders assess the chances of success for the various actions taken.

In order to find out how central the consumer is to the actions of industry stakeholders, I conducted interviews and followed discussions at conferences, blogs and in newspapers. My interview partners were regulators, investors, banks, industry associations, microfinance institutions and advisors. I spent seven months in India, from the outburst of the last crisis in October 2010 to the RBI passing a regulation in May 2011, during which I was doing an internship at GIZ in Delhi in the project ‘consumer protection and sustainable consumption’. I was working on a service that will enable microfinance clients to get independent advice on microfinance products and help them to seek redress if necessary. This project was conducted in partnership with the Indian ministry of consumer affairs.

My thesis is split in five parts.

First, I give an introduction to microfinance and a short description of the microcredit model. I explain the market imperfections and information deficits, which microfinance academics and practitioners wanted to overcome using the group lending mechanism.

I will analyse if consumers actually have enough information about products and should trust MFIs, a question that was not yet considered. An information asymmetry on the clients’ side was ignored for a long time, as were eventual negative effects of microfinance and the need for consumer protection in this field. Additionally, I give in introduction to other

microfinance products like savings or insurance and the role that consumer protection will need to have there.

In the second part I describe the highly competitive Indian microfinance market. I briefly explain how it developed, and the two main channels through which it is provided. I will explain how it is organized and regulated, and what situation the sector is currently in. I also address the issue of the crises of delinquency and bad reputation, which occurred in Indian Microfinance in the last years. This led to speculations about a microfinance bubble, which were covered in the media around the globe. Heavy competition in Indian microfinance did not lead to an improvement of the position of clients, but lead to a failure of the joint-liability-group model. The current state of Indian Microfinance shows the serious consequences that stem from the information asymmetry on the clients' side.

In the third part I summarize the outcome of the first two chapters and ask about the consequences that should follow. Knowing about the informational deficits of clients and the risks these deficits cause, may either lead to reconsidering the microfinance model and looking for alternatives or it might lead to a change in the perception of microfinance.

As alternatives to commercial microfinance I briefly present the SHG-BLP model and co-operative banks.

Most likely, commercial microfinance will remain the preferred model. I argue that the knowledge about the deficiencies of the microfinance model should result in a new perception of microfinance: Microfinance as just another – useful – financial service, irrespective of an eventual positive developmental effect. As such, it needs to meet regulatory standards just like other financial providers. A lack of information on the side of consumers is not a singularity of the microfinance market. It is equally problematic in mainstream financial markets. In order to address this deficiency, consumer protection needs to be regulated.

I give an overview of the general situation of consumer protection in India, the rationale behind regulating consumer protection and the difficulties that come with it.

In this chapter, I also compare consumer protection in Indian microfinance to the situation of low-income clients in the UK and the US financial markets. Despite very different livelihoods and loan sizes, they are surprisingly comparable. Lack of financial literacy, the lack of knowledge about the risks and costs associated with doorstep-lending and especially the need for an organisation representing the interests of poor consumers also occur in financial markets for poor clients in other countries. Consumer protection should not be mistaken for a

social programme, but needs to become a regulatory requirement that businesses have to take into account.

The fourth chapter of my thesis covers the level of consumer protection in microfinance in India. In order to create a functioning regulatory framework, the roles of all stakeholders - from the state to the individual borrower - have to be kept in mind. Additionally, I discuss the motivation of these actors to engage in consumer protection (or to refrain from it) and how they can be scrutinized.

I begin with the macro-level, describing the role of the Indian state, the federal union, the Reserve Bank of India (RBI) and the federal states. I give a short summary of the current legal framework of these entities, including the regulations in the federal state of Andhra Pradesh (AP). Here, I will also discuss microfinance as a political tool.

Not only individual institutions, but also funders, donors, banks and investors need to be governed by a set of regulations, be it by the Indian government, their home governments or self-regulating efforts.

Self-regulation plays a crucial role. First of all, regulation will not work if MFIs do not feel committed toward it. Industry associations can help to strengthen awareness, provide skills and change organizational culture. Within a regulatory framework, they should play a role in monitoring practices in the field. They can serve as a link between MFIs and the state that will be unable to monitor actual practices. However, these associations are industry bodies. They represent their members' interests, but at the same time aim to regulate and monitor them. As of now they lack credibility as they struggle with taking action against their members. The section on the role of donors, investors, and banks focuses on how well they are scrutinised by their owners and how they scrutinise the MFIs they are funding. Donors, for instance, had to explain their involvement in the Indian microfinance crisis in parliaments in their home countries.

The self-regulating efforts of industry associations and individual institutions have been important in creating awareness and are discussed in detail. While some institutions are very active in publicly promoting responsible finance, others remain unnoticed as they continue to use unethical lending practices, seeking profits as long as the sector gets shut down totally. The institutional structure of MFIs can be an additional obstacle in meeting its social mission. Staff incentives are designed to promote growth, not poverty reduction or adherence to client protection codes.

Ultimately, I cover the level of clients. As a prerequisite for consumer protection, consumers

need to understand the contracts they are signing. As in the European and the US financial market, there is a lack of comprehension of the terms of financial contracts. Additionally, microfinance clients often lack access to information because they live in remote areas. Some are even illiterate. Financial literacy trainings are a crucial instrument in addressing this need. This also needs to include information about consumer rights and legal assistance in disputes.

I end with a summary of my findings. The imperfections of the microfinance model necessitate a regulatory framework, if the microfinance model is not modified or replaced altogether. The process of commercialization of microfinance made it obvious that microfinance should at least meet the standards in consumer protection that mainstream financial products have to fulfil. The details of microfinance make it necessary that such a regulatory framework addresses all stakeholders in the process.

Indian microfinance is in a state of transformation. How the RBI's regulation will be implemented is still to be seen. Also the latest draft of the central MF Bill will be changed. There is still fear that neighbouring states of Andhra Pradesh, where the crisis happened in 2010, will follow issuing strict legislation (see e.g. The Hindu, 2011). Some expect that many MFIs will not survive the current financial year, ending in March 2012. It will be interesting to look at the situation in another year, and see how it evolves and if Indian Microfinance will consolidate.

That there is a conflict between financial success, and meeting developmental goals equally applies to other microfinance markets. Above all, governments have to take responsibility and control their financial sectors. Consumer Protection must not be optional and depend on the benevolence of the industry, but needs to be a precondition for operating in this business.

1. AN INTRODUCTION TO MICROFINANCE:

WHAT IT IS, WHY IT IS NEEDED AND HOW IT WORKS

1.1. Why microfinance developed: The imperfection of credit markets¹

The need to have a specific term describing financial products for low-income clients suggests that financial products for these differ from mainstream financial products. Catering low-income clients goes beyond lower amounts being handled. Microfinance clients usually live in remote areas, which are not reachable using the existing distribution channels. Often, they are illiterate and unfamiliar with the concept of various financial products and have no collateral to offer. It is necessary to replace the securities that financial institutions ask for by other mechanisms. Because formal financial institutions have limited information about their clients and their actions, they have no way of screening trustworthy from unreliable clients. As banks lack information, they cannot charge riskier clients, which are more likely to default, more than safe customers. To have an average interest rate, however, means that safe clients are subsidising risky ones and will eventually drive the safe clients out of the market, so that the lender is left with only risky clients (Armendariz et.al., 2010, p. 58). This phenomenon is called the problem of adverse selection. It gets even more problematic as there is limited liability: in case of default there is no way of recovering the outstanding amount, especially as there is no collateral available. Through this, the riskier clients have an incentive to use their loans for even riskier projects. If their project fails, they will not have to pay back the principal; if it succeeds, they will enjoy higher returns. The lending institution, on the other hand, has neither information on how risky the client will be when using the credit he is given, nor has it control over the client to deter him from taking excessive risk (ibid). This is called the problem of moral hazard².

It is mainly these two informational asymmetries that explain why there is reluctance to offer mainstream financial products to the poor.

¹ As microcredit was developed first, the problems were addressed there. They also exist in the market for other financial products. See also FN 4.

² Moral hazard does not only exist for credit. The lack of information about clients is problematic with all microfinance products, e.g. in microinsurance, when 'insurees don't take those precautions against bad outcomes that may have been agreed upon' (Dasgupta, P., 2007, p. 70).

1.2. The shift to microfinance

The term ‘microfinance’ has displaced the term ‘microcredit’ in the general discussion, as there has been a shift from offering only credit to providing all kinds of financial services. Initially ‘microcredit’ described institutions where ‘the focus was explicitly on poverty reduction and social change, and the key players were NGOs’ (Armendariz et.al., 2010, p. 15). As these services have broadened, the terminology has shifted from poverty reduction to financial inclusion.

‘The push to “microfinance” came with recognition that households can benefit from access to financial services more broadly defined (at first the focus was mainly on savings) and not just credit for microenterprises. With the change in language has come a change in orientation, toward “less poor” households and toward the establishment of commercially oriented, fully regulated financial entities.’ (Armendariz et.al., 2010, p. 15)

The definition of microfinance now includes all financial services:

‘The term Microfinance covers various financial products for low-income clients, who would otherwise not have access to formal financial services. This includes credit, insurance, savings, pensions, remittances, or any other financial product. Usually, this happens without the clients having any collateral to offer.’ (Smart Campaign).

This introduction gives an overview of the most commonly used microfinance products. The best known and most widely spread microfinance product is microcredit. The main focus of this paper lies on this product. In the literature on microcredit, the joint liability model and other mechanisms are described as a way of overcoming the market imperfections that I described before.

‘From the standpoint of economic theory, the group-lending contract addresses [...] information imperfections that cause moral hazard and adverse selection. In principle, the group-lending contract provides a way to achieve efficient outcomes even when the lender remains ignorant or unable to effectively enforce contracts. Moreover, in principle, the group lending methodology can potentially promote social capital, and thus further enhance efficiency.’ (Armendariz et.al., 2010, p. 128),

After describing the joint liability model, I describe the status of other microfinance variations. The lack of consumer protection was debated for microcredit in the last years, as problems arose there, but is even more relevant for other products. With credit, the risk of default lies with the lender. Clients of microinsurance, savings, pensions and remittances as opposed to loan products have to trust the institution and have to carry the risk of default on the institutions side.

‘Providing insurance poses challenges absent in providing credit. Most important, the insurance

company must earn the trust of customers, while for credit the reverse is true: it is customers who must earn the trust of bankers.’ (Collins et.al., 2009, p. 91f)

1.3. The Joint Liability Groups in Microcredit

Joint Liability groups, sometimes also called Grameen groups, are a way of overcoming the imperfect information the lender has. In this model, members avail credit either as a group or individually, but are liable for their peers. In case one member fails to repay the loan, the rest of the group will have to. This leads to low loan default rates. The risk caused by lack of information of the lending party is avoided, as members of the group are likely to choose members they trust. At the same time, a member is unlikely to default in such a constellation, as she will have a strong interest in being seen as a trustworthy member of her social surroundings. Next to this internal motivation, the group will also pressure the individual not to default, as they will have to cover for their peer. With this mechanism, the problem of adverse selection is effectively countered, as cautious entrepreneurs will group with other cautious ones and risky ones will be left with other risky ones (See Murdoch, 1999, p. 1580f). The trust of others electing someone as a group member is referred to and valued as ‘social collateral’, indicating that it replaces traditional securities. At the same time, the problem of moral hazard is addressed, as fellow group members have information about the use of the loan, and will make sure that peers are able to pay back the loan. Group members are likely to help each other out in times of struggle, which increases the chance of success of their business.

Additionally, a second incentive is used. The first loan granted is usually small. When the first loan circle is completed without default, a higher loan will be granted to the group. As a result of this mechanism, groups are less likely to default as a whole. As foreseen by Murdoch (Murdoch, 1999, p. 1583) this incentive is likely to fail in a competitive surrounding where institutions do not share client data, as groups can easily default and approach another MFI for a new loan. The instalment of credit bureaus, which share information on clients and their repayment behaviour, is one way of addressing this problem.

Even though the group model is most widely used, variations exist: There are individual loans for clients who have a need for a bigger loan, where a more detailed loan assessment is done. There, the repayment capacity and willingness has to be scrutinized. There is also urban microfinance, given to small businesses in slum areas or the like. The challenge here is to assess the stability of clients, as they are more likely to disappear and move to another city or

back to their village. Also their housing conditions are often less stable. Loans are not solely given to women. Sometimes loan conditions are more flexible, for instance in special loans for agricultural businesses, where there is no steady income throughout the year. The repayment schedule allows repayment in times of harvest. It is the group model as I described it, which is responsible for the enormous growth and profitability of microfinance. As the model is applied equally everywhere it becomes profitable by reaching scale.

1.4. Microsaving

Some argue that the most adequate and needed product for the poor is not credit but savings (see Collins et. al., 2009, p. 179). They argue that loans are used as ‘accelerators’ in building lump sums, as a way of reverse saving.

‘Loans are “accelerators” in the lump-sum-building process in more than one way. Obviously, they give households access to cash immediately rather than after a slow process of saving. But loans often have features that speed up the process even further. Price is one of them. [...]

Khadeja, who took a loan at 36 percent a year and spent much of it on gold jewelry that she saw as a vital store of value for her future, used the pressure that the weekly discipline of her microcredit provider exerted on her. [...] Khadeja saw the truth of an oddsounding paradox: if you’re poor, borrowing can be the quickest way to save. Khadeja knew that without some external force to help her, her chances of saving enough money to buy the gold necklace were small. [...]

If Khadeja and Surjo had savings tools that were safe, and as disciplined as the microfinance loans, they would have been better off, since they would not have had to pay interest. But given the options available to them, their “borrowing to save” strategy makes sense.

[...] though they also saved in informal clubs and other devices, [...] borrowing proved the most manageable way to turn their capacity to set money aside into useful sums.’

(Collins et. al., 2009, p. 110 ff)

If real saving products were offered, it would save clients the interest rates they have to pay for credit, when they actually need savings. Additionally, it would lower the interest rates for those who still take a loan, as MFIs would avoid paying for the wholesale loan they avail from banks.

‘[...] That is one very huge thing that can bring down the cost of funds. If you look at regular banks, even rural banks, the biggest difference is that they can accept savings or different kinds of deposits, and even if you give up to 7% or even 9% return on those deposits, even then that’s 4% to 5% cheaper than with banks.’ (Practitioner 3, p.c.)

If MFIs could offer savings, institutions might also be less driven by other investors, but focus on clients’ needs, as ‘MFIs that depend on external sources of donated funding often concentrate on the demands of donors rather than on the demands of potential clients, especially potential savings clients’ (Ledgerwood, 1999, p. 155).

One of the reasons why this service is not as widely offered as microcredit is that in many cases, institutions are not permitted to accept savings (Armendariz et. al., 2010, p. 169). Others argue that the real reason is that the costs for administering the savings accounts are too high (APPG, 2011a, p. 50f). The reluctance of regulators to allow institutions to accept savings shows that they acknowledge the risk of institutions disappearing with 'peoples' money'. But even without these institutions, people save in various ways:

'Poor households seek to keep money in places that they can access freely and frequently, both to maximize the amount they save and to ensure that they can retrieve the savings at short notice. Security is important, but so is convenience. Reward (in the form of interest receivable) is of less importance: Thus they may hide savings at home or entrust cash to their next-door neighbour. When households try to build savings into large sums, the mix of characteristics shifts. Now security is very important, since the money may have to be stored for some time as it builds, and reward is valued more highly. But a new characteristic enters the mix - structure. The poor, like all of us, tend to want to have their savings cake and eat it, but when you're more hungry than average, the temptation to eat it is all the stronger. Structure - in the form of curbs on the liquidity of the savings, and rules defining the term, timing, and value of deposits - helps self-discipline, as the poor often know.' (Collins et. al., 2009, p. 20)

Others argue that the existence of informal ways to save suggests that the need for saving products is actually being met by informal saving institutions, so there is no real need for formal savings products.

'How do microsavings-oriented organizations define, much less assess, their competition? How are savings-oriented institutions going to beat the many informal options people have become comfortable with? The key battleground ought to be the value to poor people of formal versus informal savings options, not poor people themselves (Make them save more! Give them financial education!). [...] If people don't manage income surpluses through bank accounts, it is because their informal options are not all that bad. Let me rephrase that, as it's all relative. Banks have not been able to deliver a level of convenience and service that induces poor people to get out of informal options.' (Mas, 2011)

Considerations like the importance of safety, accessibility and need for structure shape the design of microsaving products. The challenge to earn the trust of customers and handle the high transaction costs will pose a challenge to the development of microsaving instruments. The provision of microcredit seems to be simpler and more profitable. 'It's more profitable to keep people in debt than it is to help them save', as Malcolm Harper put it (Harper, CGAP MF Blog, 2010a).

'Paraphrasing from a conversation with Jonathan Morduch yesterday, all it takes to offer credit is to assemble a group of people who are willing to pay for the privilege of using your cash. To offer savings, you have to get regulations right, you have to figure out what you are going to do with deposits, you have to build trust with clients, you have to maintain sufficient liquidity, you have to find ways of cutting costs of serving clients dramatically which often means heavy capital investments in technology.

The fact is that savings cannot expand at anything like the pace that credit did. And therefore, the discussion about savings needs to be circumspect in terms of how many people can reasonably be reached--and that the number will be a fraction of the people reached by credit.' (Ogden, 2011, FAI Blog)

Besides the regulatory framework, slower growth rates of microsaving products are one possible reason for the reluctant provision of these services.

1.5. Microinsurance

'You have to become a responsible lender means you have to address the risk which your money is going through, not because of the usage of money, but the consumer himself is vulnerable. So the day you're able to address a vulnerable component of the consumer that is the day your completeness of your developmental impact is there.' (Ramana, p.c.)

The poor are exposed to various risks like injuries, illnesses, loss of crop or livestock, or loss of a job. Being poor leads to worse nutrition and worse working conditions, which further increase these risks (Allianz et. al., 2006, p. 4). Such problems rapidly become financial problems, as there is a loss of income and additional money is needed to cope with the situation. People often have to use their savings, sell some of their belongings and borrow from various sources (see Armendariz et. al., 2010, p. 86f.). Loans are often used to overcome these emergencies, as insurance is not available.

'But in the end, loans are not the best solution to such medical emergencies. These are problems of risk – problems for which insurance is designed. Not having insurance poses a double burden on families. First, major health-related emergencies create an urgent need for cash. Second, emergencies simultaneously diminish the ability to repay loans. [...] Only insurance arrangements (or tax-funded public safety nets) can aggregate these kinds of risks, provide urgently needed resources at the right time, and do so without creating additional obligations.' (Armendariz et. al., 2010, p. 8)

In India, nearly 80% of the population is without life, health and non-life insurance (National Insurance Academy, 2010). There are high costs to build an infrastructure to reach rural areas and there is a lack of information about clients. As clients with higher risks are more likely to take out insurance there is a problem of adverse selection. Moral hazard may occur, as the insured might change their behaviour and be reckless, which will increase the probability that they need insurance. They might take less care than they would if they had to carry the risk themselves. Additionally, for example in health insurance, having an insurance might lead to clients seeing a doctor and asking for treatments, even when they would not perceive them as necessary if they were not insured (see Armendariz et. al., 2010, p. 198f).

Micro-insurers mitigate these risks according to the insurance offered. Many microcredit products are offered in combination with loans, like the so-called ‘credit-life’ product (ibid, p.195). In case of death of the microfinance client or a close family member of the client, the insurance pays for the outstanding amount of the loan, and adds a fixed payout to the family to cover funeral costs or the like. Insurance is automatically linked to the credit product, in order to avoid adverse selection and is offered by the MFI on behalf of an insurance organization.

A way of avoiding the risk of moral hazard is found in crop insurance where, instead of insuring against bad crop, the insurance pays in specific cases of bad weather, which are likely to lead to a bad harvest.

Health insurance is less prevalent, but there seems to be demand for it. In a recent study, access to better healthcare was seen as the main reason to join insurance in rural India (Dror, 2007, p. 23).

Even when formal insurance products are available, as in India, payments are hard to manage, as they do not take into account the cash flow of clients. Also, as usually only specific risks are insured, clients might prefer to use general-purpose tools like savings or loans (Collins et. al., 2009, p. 91). Just as loans are said to be used as reverse saving, they can also be used as reversed insurance. Some MFIs offer emergency loans to meet this demand:

‘They tend to be very standardized: a fixed amount and a relatively short term of, say, three months, and intended to be taken for any purpose rather than crafted for a specific risk. They may not provide just the right sum over just the right period of time, but they help, partly because, as we have seen in this chapter, poor households are used to patching together resources from a number of providers, and a loan from a nearby source that is disbursed quickly with little fuss can be enormously valuable.’ (Collins et.al., 2009, p. 94)

1.6. Micropension

Microfinance clients also worry about how they will finance their lives when they retire. As microfinance addresses the self-employed in the informal sector, they are likely to have no income when they are no longer able to work. The life expectancy in India is 64 years (UNICEF, 2010), but is expected to rise to the age of 80 years.

‘India’s old age population is set to double to 200 million in the next two decades. About 85 percent of India’s workforce is in the informal sector and a third of them earn under Rs. 3,000 per month.

Most will become destitute when they stop working. The nuclearisation of families at all

income levels means the old will have to fend for themselves. Better life expectancy will mean more old people who will need financial support as they age.’ (Forbes India, 2010)

Strong family ties are part of the Indian identity. India is ‘a textbook case of the working of a ‘joint family system’’ (Uberoi, 2010, p. 276). The provision of welfare is traditionally seen as a function of the family (ibid, p. 291). Due to increasing mobility and labour migration, but also due to a change in values the joint family model becomes less prevalent. Many elderly cannot live with their children any more who would traditionally provide for them in their retirement (OASIS Foundation, 2000, p. 14).

Even though there is demand for pension products, institutions are reluctant to offer pension schemes. The particular challenge when offering pension products is ‘selling this pension product and keeping it active for a long term’ (Forbes India, 2010), as money might be withdrawn for emergencies. One way to counter this is to link pension products with the provision of microcredit, so that borrowers can access their funds by availing a loan against their pension savings (OASIS Foundation, 2000, p. 30). Another challenge is allowing flexibility regarding payments while having to keep transaction costs low and to scale up.

‘You need to be extremely flexible about payments, the amount and have a grassroots reach so that when the maid has Rs. 100 that she can put away, there is somebody to immediately put it away for her.’ (Forbes India, 2010)

A way to keep transaction costs low is to include a third party, for instance a NGO or MFI, to easily reach a lot of clients in order to scale up. Also, these third parties are already known and trusted by clients (Arunachalam R. , CUVMF Blog, 2011a).

One reason why there is less focus on social security might be that – just as savings and insurance - it will not generate quick successes. Additionally, engagement in a pension scheme might lead to an ideological debate.

‘The one concern which continues to bother me is that the policy is hard to sell to an aid-weary public. The appeal of microfinance was that it claimed to help people to help themselves; for a small initial outlay, the project could become self-financing. [...] People want an aid story that has a clear end in sight.

Social protection seems to be about setting up embryonic welfare states that are likely to need some aid support indefinitely, and, given the crisis over welfare dependency in many western countries such as the UK, this one is a particularly hard sell and could get entangled in domestic debates.’ (Bunting, The Guardian Poverty Matters Blog, 2011b)

1.7.The imperfections of the microfinance model: Informational asymmetries on the clients side

Information asymmetries on the lender's side like moral hazard and adverse selection have been studied at length. The mechanisms I described above were developed to overcome these problems. Strangely, however, they were merely studied from the perspective of the lender, as 'the borrowers have better information on their creditworthiness and risk-taking than does the bank' (Armendariz et.al., 2010, p. 58). It is hardly discussed that there equally is an information asymmetry towards the other side that affects the equilibrium: Borrowers do not share the same knowledge about the product that lenders have. And even if information is available, clients might lack the capacity to understand complex loan products (see Arunachalam R., CUVMF Blog, 2011b). This asymmetry between consumers and producers always exists, as Adam Levin explains:

'Now, it should hardly be controversial that there is an unequal playing field between businesses and consumers. Generally, businesses know more about their products than consumers and have more bargaining power than consumers. (Yes, there are information asymmetries running the opposite way, which is a particularly salient problem for credit and insurance products.) For many businesses, it is important to maintain this asymmetry of information and bargaining power, as there's profit in it.

In theory, and I emphasize in theory, competition should eliminate many of the problems these asymmetries create for consumers, but there's no such thing as a perfect, complete market, just varying degrees of market imperfection, so competition alone cannot be relied upon to solve everything.' (Levitin, Credit Slips Blog, 2011)

Consumers buying physical products can usually³ rely on them being safe, as they have been tested before they are allowed to enter the market. Product safety for financial products is not as self-evident for some reason.

'Consumers can enter the market to buy physical products confident that they won't be tricked into buying exploding toasters and other unreasonably dangerous products. They can concentrate their shopping efforts in other directions, helping to drive a competitive market that keeps costs low and encourages innovation in convenience, durability, and style. Consumers entering the market to buy financial products should enjoy the same protection.' (Warren, 2007, p. 9)

In the US, the recently created US Consumer Financial Protection Bureau should fill this gap. Elizabeth Warren, who advised President Obama on its development, sees the reason for this

³ In India, there are also large deficits in product safety for physical products. (The Hindu, 1999).

discrepancy in the lack of regulation: 'The difference between the two markets is regulation.'
(Warren, 2007, p. 8).

In order to overcome the information asymmetry in the financial market there is a need to regulate consumer protection (Cartwright, 1999, p. 10). I discuss consumer protection in detail in chapter 3.2.

2. MICROFINANCE IN INDIA

2.1.1. Channels of Microfinance in India:

The SHG and the JLG Model

In order to improve access to the formal banking system for India's poor, the National Bank for Agriculture and Rural Development (NABARD) has been using the Self Help Group Banking Linkage Programme (SHG - BLP) since the beginning of the 1990ies⁴. The SHG model was considered to be the 'Indian Microfinance Model', as Malcolm Harper explains:

'When I had some involvement in starting the Self-Help Group movement in Andhra Pradesh, in the early 1990s, we used to say that we've got the Self-Help Group system, and Bangladesh has the microfinance system; and we think that ours is rather better. It's linked to banks, which are secure institutions; it's cheaper, it's built on local communities, and so on. This looked like a better approach because of India's enormous numbers of rural bank branches, which Bangladesh does and did not have. So the general feeling was that this was the "Indian" approach, whereas Grameen Bank and its replicators were the "Bangladesh" approach, and it was interesting to see which would do the best job. But then, the microfinance institutions came into India around ten years ago in a big way' (Harper, Interview by Governance Across Borders, 2010)

In the SHG model, groups with up to twenty members are formed. NGOs, government agencies or banks may act as Self Help Promoting Institutions (SHPI) and initiate the formation of the group. Who decides to form a group, however, should be a matter of the group itself. As a group, members are encouraged to save within the group and start by giving small loans to each other. After having saved for 6 months and thus having established a certain savings discipline, they can participate in the SHG – Bank Linkage Programme, where the group will be linked to a local bank branch and will be able to attain credit from that bank (Ghate, 2007, p. 24f). Loans are given to the group as a whole, who then agrees on the use of the money within the group without interference from outside. An individual member can have a loan from the group according to the terms agreed on within the group. The SHG functions as an intermediary between the bank and the individual (The Hindu Businessline, 2010). The quality of a SHG and thus its success depends on the effort the SHPI invests in the formation and training of the group (Karmakar, 2008, p. 41). The lack of organisations offering these services limits the spreading of the SHG – BLP. Another reason is increasing

⁴ The model was earlier established by a NGO called MYRADA, for details see Rao, K. M. (2008), 58f.

competition by MFIs, who are using the second channel of microfinance, the Joint Liability Group (JLG) model.

In the JLG model⁵, loans are given to members of the group individually by the MFI, which acts as the intermediary between the lender⁶ and the individual. In case of default, the other group-members are liable for each other. Most commercially oriented microfinance institutions use this model (NABARD, 2007). Compared to SHG loans, MFI loans are easier to obtain and available faster. There is no need for proving a savings discipline and group trainings were less time consuming. In the JLG model, loans were immediately available without eventually having to wait for another member to repay their loan first (Sa-Dhan Microfinance Resource Center, 2006, p. 2).

The SHG model, on the other hand, is also used as an entry point for other developmental activities:

‘Seeing is believing’. The SHG members have adopted family planning measures more easily when the fellow lady adopts the same with comfort and this has a demonstrative effect, when somebody in their neighbourhood is comfortable with it. SHG is an entry point for many activities of development, not just the provision of microfinance.’ (Practitioner 1, p.c.)

It is also said to be more participatory than the MFI model and to have a greater effect on empowerment of the group members (Ghate, 2007, p. 25).

‘The biggest disadvantage of the MFI model, however, is that it is less participatory and empowering, since the ‘banking’ functions and procedures are taken care of entirely by the field staff of the MFI, who disburse and collect loans. In the SHG model, millions of poor women deal with the banks and do their own accounting and cash handling.’ (Ghate, 2007, p. 27)

The SHG-BLP also has its downsides. With the need for participation come high hidden costs for the client. Building up and maintaining a SHG takes time. For instance, SHG members have to go to banks to pay back their loan, whereas in the JLG model, instalments are collected at the doorstep (The Hindu Businessline, 2010). The default rate in the SHG-BLP is rising and was at approximately 12 percent in 2008-09 (ibid). As mentioned earlier, not all SHGs are of the same quality, depending on the SHPI. Some SHGs lack the skills in bookkeeping and accounting necessary to manage the group finances (Singh, 2008, p. 122). The success of SHGs depends on the effort and quality of the NGOs promoting them, and

⁵ For a detailed description see earlier chapter 1.3.

⁶ This might be a bank, an investor or a donor

some groups are very weak. Also, in some cases women still face problems opening bank accounts and availing a loan (Reddy C. S., 2010).

2.2. The Indian Microfinance Market before the AP Crisis

‘According to Intellecapp, the size of the microfinance market is \$50 billion considering India's 150 million poor households. Market penetration is still believed to be just 10% of what is required. In fact, 40% of India's population is unbanked, while MFIs have been able to reach only 114 million people with a loan portfolio of over \$1 billion, leaving it immense scope to grow. Which means India is the largest market for microfinance globally. It is simply an irresistible pie and everyone wants a slice.’ (Forbes India, 2009)

‘Indian MFIs doubled in numbers from 10 to 20 in this year's top 100, as their growth trends continued well into 2008, an exception to the slower growth in other markets. Even as top performers halved their annual growth rates from 200 percent to 100 percent, Indian institutions in the top 100 managed to increase their client base by an additional 75 percent over the prior year. Expanding access outside of the southern states, the hub of Indian microfinance over the last decade, has provided ample market for continued growth. Perennially low operating costs, which did not move from prior year results, kept Indian MFIs achieving high marks in efficiency, as well. On average, these institutions ranked six percentage points above their peers in this pillar.’ (MIX, 2009, p. 4)⁷, marked as in original)

‘The good news is: MFIs are growing, they need capital. And investors want microfinance exposure. They're buying MFIs like they bought IT 10 years ago’ (Reille, quoted in Reuters, 2010)

Microfinance in India is a matter of superlatives: the huge population and the tremendous poverty make it an almost endless market for microfinance. In 2007, Intellecapp estimated a credit demand of about 50 billion USD by 245,7 million people (Intellecapp, 2007, p. 26). Considering the pace of population growth in India⁸ the market seems to grow⁹ with it.

In addition, the Indian government encourages the growth of microfinance. To offer financial inclusion¹⁰ to the poor is a key objective of Indian financial politics as part of the strategy of

⁷ The MIX, Microfinance Exchange Network, is the main source for global microfinance data, available at www.mixmarket.org.

⁸ Given the census data from 2001 with a population of 1,1 billion. In the new census from 2011, 1,21 billion were counted. (Government of India. (2011). *Ministry of Home Affairs*. www.censusindia.gov.in).

⁹ I use this argument in order to show how microfinance was pushed as an investment opportunity. To calculate a demand by using the amount of poor people in India as done by Intellecapp in general seems questionable, considering that most microfinance clients are less poor and moderately wealthy (see Bateman, 2010, p. 44). It is debatable whether microfinance is demand driven at all considering the lack of alternatives (Bateman 2010, p. 37 ff.).

¹⁰ Defined as ‘the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost’ (see NABARD, 2008, p.1)

inclusive growth (Rangarajan in NABARD, 2008, Preface). In order to encourage banks to engage in microfinance, the Reserve Bank of India (RBI) made microfinance a category which banks can lend to while fulfilling their Priority Sector Lending (PSL) obligation. Banks in India are required to lend about 40% of their total lending to certain sectors like agriculture, micro and small enterprises, educational loans and housing loans. As microfinance is one of these sectors, banks can fulfil their obligation to ‘aim at raising the proportion of their advances to priority sector to 40 per cent’ (RBI, 2010). Besides offering the service themselves, they can fulfil their quota either by participating in the Banking Linkage Programme or by providing wholesale lending to MFIs. At the moment, there are debates that commercial MFIs might lose priority-lending status, which would make accessing funds more difficult for them (Economic Times, 2010). The Malegam Report¹¹, which proposed a regulation for microfinance non-banking financial companies (NBFCs) was granting the newly established NBFC-MFIs PSL status. Those MFI NBFCs would have to fulfil stricter requirements.¹²

In addition to promoting microfinance by such regulation, the state is also the biggest actor in microfinance in India, with NABARDs SHG – BLP (GTZ et. al., 2008, p. 22).

The BLP had 48.5 million loans to SHGs outstanding by March 2010 (NABARD, 2010, p. i). Given that an SHG on average has 15 members (NCAER, 2008, p. 1), this would mean that approximately 727.5 million people were covered. In the financial year of 2009/10, 144.53 billion rupees¹³ of loans were disbursed (NABARD, 2010, p.i.). According to the RBI, 58% of the outstanding loan portfolio is accounted for by the SHG-BLP, 34% by NBFCs and 8% by others like NGOs. This does not include co-operatives or thrift (RBI, 2011a, para 2.5).

Although MFIs still have smaller numbers compared to the SHG BLP, their size and growth is still spectacular in the global perspective of microfinance. In the financial year of 2009/10, the 150 MFIs reporting to MIX had 26.6 million active borrowers. The gross loan portfolio by all of them was 4.4 billion USD (MIX, 2011a). By March 2010, out of the ten biggest MFIs (by borrowers), four were Indian.

¹¹ Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector, see 2.3.2. and Appendix.

¹² This will be discussed in detail in chapter 6.1.2.

¹³ 3.2 billion USD, using the rate of March 31st, 2010, 1 INR = 0.02221 USD

With this background, in July 2010, SKS, the biggest Indian MFI with around 5.8 million clients at that time (MIX, 2011b) entered the stock market to pave the way for a new superlative in Indian microfinance. It was the second IPO of a MFI after the Mexican MFI Compartamos in 2007 (The Economist, 2010b). By the end of 2010, SKS had 7,7 million clients¹⁴ and the amount disbursed was 4.792 million USD (SKS Microfinance, 2011).

‘By market standards, the SKS IPO is a great success. Institutional investors have over-subscribed their allocations by 13 times, and the company’s valuation of USD 1.5 billion came in at the top end of the offer band price.

This sky-high valuation represents 6.7 times the company’s post issue book value, and about 40 times the company’s fiscal year 2010 earnings.

Such multiples are not in line with market peers. In emerging markets, banks are valued at 3 times the book value, while finance institutions serving low-income customers are trading at 2.6 times the book value. The SKS valuation is even higher – by a margin – than Compartamos’s valuation in its landmark 2007 IPO. At listing, Compartamos was valued at 27 times the company’s historical earnings although its 2006 return on equity (ROE) at 55% was more than double the ROE of SKS today.’ (Reille, CGAP MF Blog, 2010b)

In this scenario of high spirit and high valuations, the biggest crisis the microfinance industry has yet seen happened, which changed the environment and perspective of microfinance in India. This will be discussed in chapter 2.4.4.

2.3. Legal Framework of Microfinance Providers

2.3.1. Constitutional Competence to regulate microfinance

As India is a federation, government powers are split between the union and the federal states. Article 246 of the Indian Constitution¹⁵ provides that the legislative power is either with the union, the state or both. Who is competent to regulate is fixed on lists, which are attached to the constitution. Microfinance is a cross-sectional issue, it can be tackled from the financial side (art. 43), the competence to regulate corporations¹⁶ or, under the competence for money lending and relief of agricultural indebtedness (List II, art. 30 of the 7th schedule).

This leads to uncertainty in whose competence the regulation of microfinance is in the federation, which complicates the regulation of the sector. In the recent Microfinance Crisis in Andhra Pradesh, the State Government issued an ordinance on the basis of their competence for money lending laws. The ordinance was then challenged under the aspect of the AP

¹⁵ For a selection of relevant provisions see Appendix.

¹⁶ Which is with the union, if the object of the corporation is not confined to one state (List I, Art. 44) or the state, if otherwise (List II, Art. 32)

Government not having authority to issue this ordinance as financial corporations are a union competence (The Times of India, 2010b). In the Malegam Report, the RBI is arguing that the AP government was right regulating NBFCs in that regard, as the RBI had not made use of their competence until then.

This indicates the RBI's view that the legislation it will pass will supersede over the AP act. The RBI's view on this is that it has the competency to regulate, but the state was right in regulating as long as the RBI was inactive.

'In the RBI act, there is a part that very clearly says, the RBI can regulate, or can give directions regarding lending by NBFCs, it has so far chosen not to do it. Now as long as it chose not to do that, it so far only looked at deposits (the asset side), or at the liability side, it looked at the management of the liabilities, the mobilization of liabilities by NBFC, not the utilization of assets. Now as long as it did that, the moneylender laws of the state apply, the moment the RBI acts under the union act to give directions on lending, this becomes unfunctional, a state law will not prevail.' (Rajagopalan, p.c.)

The AP government contested this view and claims that it is nevertheless competent to regulate microfinance (The Hindu, 2011a). It still sees a need for regulation, at least as long as the RBI does not have explicit and detailed regulation on consumer protection issues.

'The government cannot regulate the financial soundness, the methods of operation which is the domain of the RBI. The area of concern is the clients; and the ordinance is there to protect the clients from the clutches of MFIs. If this issue is addressed, the state government being a sovereign government, having a legislative body, might take a decision on the ordinance.' (Practitioner 1, p.c.)

The newly suggested draft of the (central) microfinance bill, which is scheduled to be discussed in Parliament in the winter session 2011 simply declares that 'micro finance services extended by any micro finance institution registered with the Reserve Bank shall not be treated as money-lender for the purpose of any State enactments relating to money-lenders and usurious loans' (MFBill 2011, explanation to para 42) and seeks to resolve the constitutional conflict in that way.

2.3.2. Institutional Organization of Microfinance Providers

As a further complication, microfinance can be provided by differently regulated entities, like banks, NBFCs, NGOs, or co-operatives. Banks and NBFCs fall under the regulating authority of the RBI, for NGOs there are federal acts. NGOs can be trusts or societies. Trusts are regulated by state acts, for societies there is a nationwide act, however, with additional varying state acts (USIG Council on Foundations, 2011). Depending on which of these

organizations is giving credit, there are different regulatory schemes and different rules. The reason for these different rules is the stricter regulation of banks and NBFCs compared to NGOs (Rajagopalan, p.c.).

In the early days of Microfinance, there was a need to register as a bank, like the Self Employed Women's Association in Ahmedabad (SEWA) did. In the 1990ies more and more NGOs started entering the market, co-operating with SHGs, as the SHG-Bank Linkage programme was mainstreamed (Rao, 2008, p. 58f). Besides the need for capital and administrative efforts, the RBI has in general been very reluctant to admit new banks in India (Alok, p.c.). This is one of the reasons for the prevalence of the NBFC model in microfinance.

As mentioned above, NGOs are either registered as trusts, societies, co-operatives or section 25 companies¹⁷. Legally they are not permitted to engage in commercial operations, as they are non-profit organizations. This also restricts them from borrowing funds (Rao, 2008, p. 60f).

With scaling up microfinance on a for-profit basis, there was a need to register as a for-profit-company¹⁸. The most common option for MFIs was to turn into Non Banking Financial Companies (NBFCs). NBFCs need certification from and are regulated by the RBI under the Companies Act 1956. Any company engaged in microfinance falls under the RBIs definition in Section 45-I of the Act and thus has to register with the RBI. In order to avail a licence, it has to fulfil a minimum capital requirement. Most upscale MFIs are organised like this, as investors are more confident in institutions regulated in this form. International capital in an NBFC cannot exceed 50 per cent (Sa-Dhan, 2006, p. 25ff).

After the issuing of the ordinance in Andhra Pradesh, a Sub-Committee of the RBI, the Malegam Committee, which was appointed to make recommendations on the future role of the RBI in Microfinance, suggested to create a new legal form: NBFC – MFIs (RBI, 2011a). A lot of further restrictions go along with this new legal entity, like a maximum loan size of 25 000 Rupees, an interest rate cap at 24% and also a prohibition to provide doorstep service, to name a few (RBI, 2011a). In May, the RBI decided to accept the framework of the recommendation (RBI, 2011b, p. 18f). Detailed guidelines have not been issued yet, but after

¹⁷ For a detailed view see: Sa-Dhan, 2006: Existing Legal and Regulatory Framework for the Microfinance Institutions in India; or Rao: MFIs in India, in Karmakar, 2008 p. 54 – 66.

¹⁸ Some NGOs are split in for profit and not for profit entities, RBI regulation does not apply to NBFCs licensed under Section 25 of the Companies Act, see Rao, 2008, p 60.

stakeholder discussions the maximum loan sizes have been increased to 60 000 Rupees and are now regulated more flexible for different loan products.

What is still missing, however, is a unified regulation that also includes banks, NBFCs and NGOs (CRISIL Ratings, 2009, p. 4). The revised microfinance bill is expected to solve this issue, but still has to be adopted in parliament.

As discussed above already, both NGOs and NBFCs are not permitted to collect savings. NBFCs claim that is the reason why they need to turn to investors in order to attain capital. Alternatively, they get funded by banks at rates of around 15% - being able to collect savings would give them a cheaper resource of credit and would allow them to reduce interest rates (Practitioner 3, p.c.).

Banks and co-operatives are permitted to take savings; co-operatives can only accept savings by their members though.

Like with any regulation, it is a challenge to arrive at an adequate level of protection. Overregulation might lead to counter effects like high administrative costs that will increase the loan fees for consumers, or anti-competitive effects.

The RBI has recently allowed the use of shop owners and the like as business correspondents to increase financial inclusion. It is being discussed to also allow the use of for-profit corporations as business correspondents (Srinivasan N. , SSR, 2010, p. 5).

2.4.Recent developments and challenges

In the 2011 edition of the Banana Skins Report, an annual report on the risks in microfinance, based on a survey with stakeholders globally, the ten biggest risks named by Asian Stakeholders¹⁹ were: political interference, reputation, credit risk, liquidity, inappropriate regulation, competition, mission drift, corporate governance, management, and product development, in that order (CSFI , 2011, p. 19).

All these factors played a role in the events happening in the last years. As discussed earlier, microfinance in India has undergone a lot of changes, from being funded by donors to becoming more commercially oriented, attracting equity investors and even entering the stock

¹⁹ 82 out of 107 Asian Stakeholders questioned were Indian. (CSFI, 2011, p. 4)

market. The growth of microfinance hardly led to spreading microfinance to areas that previously had been without access to financial products. It was mainly concentrated on certain pockets where a lot of MFIs were already operating. These areas were favoured, as the product was well known and functioning, so costs and risks for newly entering MFIs were low.

In the last years, the Indian microfinance market experienced three major crises of massive default, where microfinance stakeholders were antagonising other stakeholders in the rural political economy. These events explain why political interference, reputation and credit risk are seen as the biggest risks by MFIs. I will discuss these crises in the following.

2.4.1. ‘Liquidity makes markets; too much liquidity makes bubbles.’²⁰

‘Should we be over concerned with their grotesque profitability (at least up until recently)? It’s really two questions, sustainability is a donor weasel word, it means profitability and I suppose on balance it’s a good thing that thanks to the efforts of DFID microfinance is now a profitable business. But it has gone too far, become too profitable and therefore burst, like in so many places financial institutions do burst when they go too far, when they get too silly.’ (Harper, APPG Inquiry, 2011)

The tremendous growth of the Indian microfinance market has been compared with the US mortgage market and the crisis that followed (e.g. The Wall Street Journal, 2009, The Economic Times, 2010d). Like for the US subprime credit market, it is also true for the Indian microfinance market that in ‘a hasty pursuit to acquire clients and maximize profits, a number of undesirable, fraudulent or deceptive practices were carried out’, including a lack of due diligence in the assessment of the clients’ repayment capacity. Also, the flourishing of the market, the availability of capital and the fast growth of the microfinance sector have seemed to alarm observers of financial markets, especially with reports on over indebtedness (Microfinance Insights, 2010, p. 46).

‘If companies try to sell more soap or fertilizer than the market can absorb, prices fall and inventories bulge. If companies try to sell too much credit, demand can seem to keep up with supply for years. Oversupply covers its own tracks as people use new loans to repay old loans. Put otherwise, microcredit is a prescription drug—useful in moderation, but dangerous and even (metaphorically) addictive in large doses. Overborrowing is a particular concern for people close to the edge of survival. Yet as the global financial crisis has exposed, when the money is easy, investors and their intermediaries have strong incentives *not* to worry about

²⁰ The Economic Times (2010).

whether the money is well lent. The recent microcredit crashes are perhaps the first bubbles in history fueled more by generosity than greed' (Roodman, forthcoming, p. 11 (draft))

MFIs wanted to grow to attract investments. As I described earlier, the fastest growth was possible in certain pockets, which were easily accessible, densely populated and where people already knew the product. So, in order to attract investments with the promise to continue this growth, institutions focussed on areas where people already had loans. This led to multiple borrowing and eventually to clients' over-indebtedness. In the three cases that are discussed below, the bubble burst, as people were unable to continue to repay and formal institutions - be it the state or a religious authority - sanctioned MFIs.

The Indian microfinance crisis also resembles the US subprime crisis in the reaction to the crisis. In the US, the Consumer Finance Protection Bureau was established, in India, regulation by the AP government, the RBI and the central government followed. The need for strengthening consumer protection in order to avoid such situations will be discussed in detail in chapter 3.2.

2.4.2. The Krishna Crisis in 2006

Already in 2005, borrowers in Andhra Pradesh complained to politicians about bad practices of MFIs. MFIs on their part were worried that the AP government might include them in 'a proposed amendment to the State Moneylender's Act providing for interest rate ceilings' (Ghate, 2007, p. 87). This did not happen back then, but in the following year, the district officer 'of the Krishna district seized the records and closed about 57 branches of Spandana and SHARE in the district, the two largest MFIs in the country, as well those of a few smaller MFIs' (ibid, p. 86). Borrowers were given the impression that there was no need to repay, so repayments went down to 10 to 20 %. The field staff was reluctant to enter these areas, as there was such a hostile atmosphere against them (ibid). The reasons for this so-called Krishna-Crisis were soon established:

'One of the longer-term causes was clearly the 'quest for numbers' relating to outreach and profitability that is the main motivation of many MFIs. [...] The crisis serves as a useful reminder that there are other just as important client-centred consumer protection objectives [...]. We are all responsible for building up a climate of expectations [...] that celebrates the [...] rate of growth of outreach, efficiency, field worker productivity, and so forth, without always remembering that they can: (i) lead to short-cuts in client selection and training, field worker training [...] and loan size determination; (ii) be used as the only criterion for incentive payments to field workers; and (iii) put a degree of pressure on them that leaves no time for

issues affecting client satisfaction [...]. The set of accusations that received the most prominence, however, related to coercive collection practices, leading to borrowers having to 'abscond', or migrate out of the village, and even in some cases, allegedly, commit suicide. [...] The third set of accusations was that MFIs were 'dumping money on borrowers', who were finding it difficult to repay and having to borrow from moneylenders at a higher cost [...] A final underlying cause was that the MFIs [...] under-estimated the degree to which they were antagonizing several powerful players in the local political economy.' (ibid, pp. 93-100)

The introductory summary of the State of the Sector Report 2006 saw the Krishna-Crisis as an opportunity to learn:

'[...] Better to be woken up this way than not at all. The consensus is that the sector will emerge stronger if it reads the lessons the right way, and conjures up the collective will to implement them. The experience has left many observers less sanguine about the sufficiency of self-regulation left to itself [...].' (ibid, p.18)

This crisis initiated the first efforts of regulation. In March 2006 Sa-Dhan's code of conduct was issued (ibid, p. 88). Just as well, the RBI published their fair practices code for NBFCs (ibid, p. 90).

2.4.3. The Karnataka Crisis in 2009

Despite the warning after the crisis in Krishna, which was supposed to 'wake up Indian microfinance', MFIs continued to grow, and another crisis happened in 2009 in the State of Karnataka.

In the financial year of 2008/09 the number of clients in Karnataka grew by 64%, with this growth being concentrated on the southern districts which are better developed and have denser population (EDA Rural Systems, 2010, p. iv). In Karnataka, with 11.6 million households of which 2.77 million were poor, the estimate of the number of microfinance accounts in March 2009 was 7.31 million (Srinivasan N., SSR 2009, p. 72).

'In Kolar town, the epicentre of this crisis, microfinance clients are likely to have an average of three loans each. Client information from seven of the 9 MFIs operating in the town shows that at least 33% of them have more than one loan and around 20% have three or more loans. More significantly, the opportunity for borrowing from multiple MFIs has resulted in debt from these seven MFIs of around 150 clients (out of 12,000) in Kolar town rising to levels of Rs 45,000 (\$1,000) and beyond, mostly exceeding the commonly accepted definition of microfinance in India' (EDA Rural Systems, 2010, p. iv f)

In this scenario, next to an increasing indebtedness, the silk and handicraft business, on which many livelihoods were depending, deteriorated. This additional problem made it hard to meet payments (Srinivasan N., SSR 2009, p. 74). After a suicide happened in January 2009, the

local muslim authority called Anjuman Committee was informed which ‘irked by months of complaints about women “neglecting” family duties, families led into crippling debt by the culture of “easy money” that had developed in the town and oath taking at meetings invoking hindu goddesses, intervened in the only way it knew: interaction between MFIs and muslims in the town was prohibited by religious edict’ (EDA Rural Systems, 2010, p. v).

The Anjuman Committee argued that lending and borrowing on interest was ‘haram’ and against Islamic law, as was the interaction with men from outside, the neglect of family by the women who had to attend several centre meetings as they had taken several loans. Besides these issues, which were religiously motivated, there was also criticism of recovery methods in case of default, as there was a practice of loan officers to stay in the house until the loan was repaid. The interest rates were felt to be very high and repayment was felt to go beyond the capacity of women, forcing them to undertake “undesirable jobs and activities”. (Srinivasan N., SSR, 2009, p. 72)

Youth groups came to borrowers houses and spread the fatwa and so a few days later, the majority of Muslim clients defaulted (EDA Rural Systems, 2010, p. 7).

‘This was followed by further vigilante action – such as chasing away of MFI staff – by youths armed with sticks [...] The youth took clients’ repayment cards away. MFI staff were also attacked and beaten up in some of the colonies. In one colony, some group members paid their instalments the following week but were harassed by their neighbours and other group members. They stopped repaying thereafter for fear that their neighbours would complain to the Anjuman.’ (ibid, p. 7)

As 65-70% of microfinance clients were Muslim (ibid, p. 5). The committee issued a fatwa and spread it at prayers, advising not to pay back or take up new loans and threatening with social and religious sanctions in case of acting against it. The sanctions included denial of last rites, boycott of social functions, and even excommunication (Srinivasan N., SSR 2009, p. 71).

In the following, rates of delinquency also increased in neighbouring districts, either with reference to the Kolar Crisis or following announcement of local religious authorities that there was no obligation to repay (EDA Rural Systems, 2010, p. 5). Again, as in AP three years earlier, despite all religious connotations, MFIs were accused of over-lending and coercive recovery practices in order to expand their businesses. Again, the crisis was discussed in the industry and again, there were warnings stressing the need for responsible growth:

‘Kolar reminds us of some lessons from AP that the sector has forgotten. Regardless of the proximate cause reported, the underlying reason for such a development is seen to be the fatigue that has set in among the borrowers arising from excessive debt. A combination of borrower wants and expectations and the MFIs’ ambitions on expansion had led to an excessive debt level that was not applied for income generation by the borrowers.’ (EDA Rural Systems, 2010, p. 76)

2.4.4. The Andhra Pradesh Crisis of 2010

Despite all warnings another crisis happened in 2010. Shortly after the overly successful IPO of SKS, the so far biggest crisis happened, which was also reported in global newspapers. There were reports on the ‘deadly spiral of microfinance debt’ (The Guardian, 2011). Microlenders were compared with ‘loan sharks’ making ‘hyperprofits off the poor’ (The New York Times, 2010, quoting a senior official from AP). In October, the AP Government released an Ordinance, arguing that the SHGs they had built up were ‘being exploited by private Micro Finance Institutions (MFIs) through usurious interest rates and coercive means of recovery resulting in their impoverishment and in some cases leading to suicides’. This would make it ‘expedient to make provisions for protecting the interests of the SHGs, by regulating the money lending transactions by the money lending MFIs’ (AP MFI Ordinance, 2010).

The Ordinance made it obligatory for MFIs to register at a State Authority and to provide information on the interest rate charged. It ordered - besides other things - that people were allowed to be members in one SHG only, that all payments were to be made at the Panchayat²¹, and it ordered MFIs to seek approval from the Registering Authority to grant a new loan. Monthly, MFIs were supposed to submit statements with a list of borrowers, loans given, interest rate charged and repayments.

As a penalty for carrying out business without registration it provided for imprisonment for up to three years.

The process of registration lead to a halt in collections in AP. Field workers were arrested and, even when collections were permitted again, they were still scared to collect outstanding loans out of fear of physical aggression by clients. As time passed, institutions were losing more and more money. At this point, these losses pose a serious risk to the future existence of MFIs that are mainly active in AP.

²¹ A village centre

The ordinance was later turned into an act. As I mentioned above, it is unclear if it is still valid as the RBI has passed legislation and it is unclear if it will stay valid in case the central government passes legislation. The ordinance and act led to repayment rates falling from 99% to below 10% in AP (Forbes India, 2011). Many MFIs stopped lending to clients, which led to even less being willing to pay back their loans. The incentive that they would be able to avail another loan after repaying the current one fell away. At the same time, banks, which provided 80% of the capital to MFIs, stopped lending to MFIs. Investors have ‘pretty much walked away from this sector’ (Mahajan in Forbes India, 2011).

In July 2011, BASIX, one of the top five Indian Microfinance Institutions, which is also known for being an ‘ethical investor’ (livemint, 2011), announced that it would not survive without fresh funds as they had accumulated bad loans worth 450 crores Rupees (Rs.) since October 2010. The worth of BASIX decreased from 230 crores Rs. to 128 crores Rs. in that time. In August BASIX received 800 crores Rs., so its survival is saved for some time (Microfinance Focus, 2011). Still, many other institutions face similar struggles.

SKS in August 2011 halted lending in AP, claiming that the AP government had approved less than two per cent of loan applications (ContifyBANKING, 2011). The SKS stock price, which was initially rising after the IPO, dramatically fell at the time of the AP crisis. From a peak of 1,490 Rs. worth in September 2010 (Reuters, 2011), the stock dropped as low as 268 Rs. at one point.

There is speculation that another crisis is brewing in Tamil Nadu, where a Public Interest Petition was filed. It seeks a direction to the RBI, ordering it to investigate unfair and illegal practices of MFIs. The petitioner’s counsel was quoted arguing that ‘the malady that had infected Andhra Pradesh is infiltrating into our State [i.e. Tamil Nadu, author’s note] also. While Andhra Pradesh had brought in an ordinance to check the menace, the Tamil Nadu Government is yet to do so’ (The Hindu, 2011b).

3. CONSEQUENCES FOR THE FUTURE OF MICROFINANCE

The commonly used JLG microfinance model suffers from an information asymmetry, which MFIs considered insufficiently in their lending practices. Field practices and standards intending to educate clients could not bear up against the pressures of competition. This can be studied looking at the status of Indian microfinance.

Especially donors and governments, but also ethical investors should reconsider their position on microfinance. They should seek to either find alternatives to the current microfinance models, or, if they do wish to continue engaging in microfinance, see it with clear vision: As a financial service that does not differ much from financial products for the mainstream market. It can be useful to its clients, but just as well entails risks, which have to be mitigated. In the mainstream market, the major tool to combat these risks is consumer protection. But both in the mainstream and in the microfinance market, consumer protection is not a development programme, but a business requirement. Microfinance is a business, so adequate regulation should apply.

In the next chapter I very briefly describe the alternative options of financial services for the poor. Some feel that banks should be encouraged to directly engage in microfinance, others feel the SHG-BLP should be strengthened, or that the focus should shift to co-operative banks.

Still, as I described earlier, currently a lot of microfinance is provided by MFIs, using the JLG model. While stakeholders might consider changing their tactics, a way to deal with the current state needs to be found. Similar to mainstream financial products, microfinance requires consumer protection - as a way to correct the information deficit of borrowers. This can either be done by educating clients or by prohibiting certain practices from the start. In chapter 3.2., I give a theoretical overview of consumer protection, while in chapter 4 I discuss the challenges of implementing consumer protection, taking into account the many stakeholders involved in Indian microfinance.

3.1. Alternatives to Commercial Microfinance

One option to deal with the imperfections of the JLG model is to reject it as such and seek to find and strengthen alternatives, which have a stronger focus on developmental effects or are

easier to monitor. Some argue that, for those looking for development impact, the SHG-BLP should be the preferred model, as the client relationship is more central there.

‘The reason is, there is better governance, better monitoring and they understand the consumer well, because their members, they know each of them. So even if the leader of a self-help group can make a better assessment of a customer and customer need and their financial requirement than the biggest financial institution which can come and make a credit assessment. All you have to do to get them is to what information you require and to make an assessment how much to give. And I think, fundamentally the social capital is there, relationship, I’m talking about customer relationship. Protection comes out of the relationship. I will only know your vulnerability if I know you. Otherwise I can come in a different form, you may fall for me and give a loan, but I have nothing. [...] I am seeing the SHG groups from a different angle: They have social capital, they understand the customer, they understand the vulnerability of each member of the group. So they know exactly how much she can take and how much she can repay. Even if she wants more, they will not give, because she can’t take it. [...] When social groups, or SHG groups, if they work with the principles by which it was set up, it will be fine. You spreadsheet it, make some 15 members in a computer, the members are there, the signatures are there, you’re looking by those parameters which are what you can put in the computer, if that is the way you want to judge and give the loans, like some people tried in Tamil Nadu or something. Just the names and the signatures and fingerprints, so it matches. But with no social bonding, no time spent on group formation, it takes about 15 000 Rs, and about 6 months to form a tier group which is well functioning. But if you don’t spend that time, I’m talking about a good group which is a SHG group, but if you think NGOs are useless, all you require is 15 names and 15 signatures and then it’s a group, they will fail.’ (Ramana, p.c.)

While the developmental effect of the SHG-BLP is certainly there, in the past there have been issues with the lack of quality of SHGs, as I pointed out in chapter 2.1..

Others argue for strengthening co-operative banks:

‘I think that the focus should be on getting banks into microfinance, not on promoting special microfinance institutions which, at least the experience in India shows, make a great deal of money, at least for a while, out of getting people into debt and in a way don’t want to take savings. [...] Donors should [...] never give capital for lending, they should be forced to borrow from banks, or better, to take it from savers. Again its old hat but the cooperatives, that route of credit unions or Mutuelles, that is surely the preferable route for consumer financial services. Sadly it is one that is diminishing in importance.’ (Harper, Interview by Governance Across Borders, 2010, p. 4)

Co-operatives are seen as favourable as they are institutions, which are owned by people. Profits and savings of its members stay with the community, where they will also be invested. This leads to further economic growth in the area. Also, the fact that members have a financial stake in the co-operative bank leads to a wise choice of management.

‘Without financial stake, members tended to choose flamboyant persons who were good at accessing dole or credit. With high stakes, they opted for strict disciplinarians and financially prudent persons as leaders.’ (Rajagopalan in The Economic Times, 2010b)

Furthermore, these institutions are transparent, as they present their audited statements (ibid).

That co-operative banks are hardly discussed is surprising, but might stem from the fact that they lack advocates. They are neither of interest to private investors nor owned by governments who would see a role in protecting them. Apparently, the regulatory framework has even become less favourable towards co-operatives. A circumstance, which might even stem from the empowering effect of co-operative banks, as Shashi Rajagopalan speculated:

‘There are the most appalling laws, for example in Andhra Pradesh, we do have a good co-operative law, but in the last five, six years, the department refuses to register co-operatives under that law. Now as a result, people’s choice of running their own organisation has gotten very severely restricted. Then, you have only third party players coming in, and at that, they can form a cartel quite easily. In true competition, all forms of organisations must be allowed to flourish. No one form should be stifled. Here in India we have stifled the co-operative form of organisation. [...] That’s because co-operatives consist of large numbers of members from contiguous areas, and contiguous areas means vote-banks. And no legislator wants a co-operative leadership to emerge, which can threaten him or her. And that’s where it comes from, where the entire approach to poor, a very paternalistic approach to poor comes from, ‘oh you can’t do it by yourself, let the state do it for you’.’ (Rajagopalan, p.c.)

While the RBI, NABARD and some state governments have established a committee to study co-operative societies as contributors to financial inclusion (RBI, 2011b, para 91), and the RBI is trying to ‘revive the [...] rural co-operative credit structure’ (ibid, para 90), co-operatives are hardly part of the discussion within the microfinance community.

Unfortunately, alternative sources of microfinance have been given little attention in the debates following the AP crisis.

3.2. Consumer Protection

Besides changing the model in which financial services are provided to one which focuses less on profit, another option is to keep the model, but treat it like other commercial financial services. Similar to the situation in the US after the subprime crisis, following the crisis in India there quickly started a discussion on the need for consumer protection to help avoid such problems in the future. Behind this lies the rationale that, if consumers were well informed about the contract they are signing and their rights, the situation would not come to the point of suicides, massive defaults, political action and bad press.

‘The roots of the global financial crisis, which started in 2008, lie partly in a failure to regulate. Now more than ever, policy makers and regulators face increasing questions over whether and how to regulate consumer credit so as to protect borrowers.’ (Porteous, 2009, p.1)

Still, the need to protect microfinance clients astonished some, as microfinance, with its mission to serve the poor, giving them dignity and empowerment (e.g. Govindarajan, Harvard Business Review Blog, 2010), would not give a reason to ask for additional protection. Even before it hit the headlines in global newspapers, microfinance practitioners feared that MFIs might ‘simply transmute into a ‘feel-good’ version of the sort of ‘doorstep lending’ organizations found in the developed countries’ (Bateman, 2010, p. 130).

For some reason, consumer protection efforts usually focus on the middle class rather than the poor.

‘Consumer protection is also attacked, usually covertly, for being ‘middle class’, the middle classes for this purpose being defined as those with the opportunity and education to look after themselves. The implication is that the poor are out of reach of this movement since they are too ignorant or under too many pressures to resist exploitation.’ (Harvey, 1978, p. 15)

This holds also true for India. Considering the Asian Development Bank’s definition of poverty, still three quarters of the population do not reach the middle class as they earn less than two Dollars a day (von Braunmühl, 2010, p. 403)²². Poor consumers in India - mostly living in rural areas - hardly have any knowledge about consumer rights and where to turn in case these get disobeyed (ibid). Poor consumers also face additional challenges, especially in credit markets:

‘For most goods and services the careful poor consumer can avoid those who seek to ‘exploit’ the poorer end of the market and purchase in the mainstream markets. [...] However, in the credit market poor consumers lose being part of a wider consumer collective. [...] in credit transactions the creditors’ interest only starts once the bargain has been struck and (s)he starts to receive payment. [...] illness or unemployment may cause them quickly to fall behind with payments. [...] the credit market appears to be ultimate in individualism, stripping consumers of any protection afforded by being part of a crowd and forcing them to seek out the best terms their situation permits.’ (Howells, 1999, p. 244f)²³

²² The Indian government set the poverty line - which entitles the poor for benefits of welfare schemes - at 32 Rs. (for urban areas) and 26 Rs. (for rural areas) (0,7 USD/0,57 USD, using the rate of March 31st, 2011). This number will be revised eventually. (See Times of India, 2010c).

²³This quote describes the credit market for low-income clients in the UK. Differing livelihoods make a comparison of the credit market a bit far fetched, especially as there is no practice of group lending. Still, some aspects are comparable: the issue of doorstep lending with the involved pressure and limitation of choice, and the high costs leading to high interest rates. Also, the use of credit as reverse saving, to help managing the budget or in an emergency and the limited negotiation power and knowledge about consumer rights and the credit product can be seen in both credit markets. See Howells, G. (1999). Seeking Social Justice for poor consumers in credit markets . In P. Cartwright, *Consumer Protection in Financial Services* (S. 239-263). Kluwer Law International.

That microcredit is often offered using the group model does not contradict the argument of lack of protection of being part of a crowd. There is a mass of consumers in the market, but they are not mixed with better off consumers, as described by Harvey, meaning such who 'look after themselves' and fight for better conditions which would then also improve the situation of poor consumers.

Also, the barriers to contest unsound practices as an individual client are higher for poorer, less educated clients. In India, there is no collective organised institution acting and lobbying for poor consumers' rights and interests. Until recently, the lack of attention by the regulator facilitated the infringement of consumer rights by microfinance providers:

'In microfinance today, growing numbers of practitioners are relying on practices that would be considered illegal or unethical in mature financial markets – untrue information, unlawful repossession, and usurious interest rates in particular. Lack of adequate customer protection in emerging markets thus easily opens the door to exploitation of poor people.' Alliance for Fair Microfinance²⁴, quoted in Bateman, 2010, p. 131)

3.2.1. Why should consumer protection be regulated?

Broadly, there are two main theoretical approaches to answer why there should be consumer protection.

The first one is a paternalistic model, where it is argued that, as there is such a vast power imbalance between the two contracting parties, the state needs to assist the consumer. The company has better knowledge of its product and usually more money and legal knowledge to fight causes at court. Also, it usually drafts the contract, as it would not make sense to agree on a contract with every single client who would lack the legal expertise and interest to do so (see Harvey, 1978, p. 13f).

The second approach sees the importance of consumer protection in the power of consumers to shape the market. A strong consumer will pressure companies to develop the best, safest and cheapest products, and will make an economy stronger. Just as products get improved and safer by regulating product safety, financial products are likely to improve by regulation.

'Just as the Consumer Product Safety Commission (CPSC) protects buyers of goods and supports a competitive market, we need the same for consumers of financial products—a new regulatory regime, and even a new regulatory body, to protect consumers who use credit cards,

²⁴ Their website (www.fairmicrofinance.org) is offline, the discussion forum (finance.groups.yahoo.com/group/fairmicrofinance) has not been used since 2008.

home mortgages, car loans, and a host of other products. The time has come to put scaremongering to rest and to recognize that regulation can often support and advance efficient and more dynamic markets.’ (Warren, 2007, p. 9f)

Measures go beyond countering the inequality of bargaining and include ‘anti-monopoly legislation, control of excessive or misleading advertising, full disclosure requirements, power to reopen extortionate bargains, better access to the legal system for the unrepresented consumer, and consumer education programmes’ (Harvey, 1978, p.20).

Another way of arguing in favour of consumer protection from the business angle is by pointing out that it will increase the company value. In microfinance, this translates to not lending beyond debt threshold levels of clients (see e.g. Access, 2011, p. 5).

Protection for microfinance consumers should hold both approaches in mind:

First, as already noted, microfinance clients, more than middle class consumers, face a strong imbalance in the negotiating process.

There is a ‘[...] *huge imbalance of power, information and resources* between consumers and MFIs, with low-income consumers at a great disadvantage. [...] While MFIs/FIs know their products rather well, the individual low income consumer often finds it difficult and/or costly to obtain sufficient and transparent information regarding the various financial products that they access from MFIs. In addition, many of the low income people find MFI financial products naturally complex and/or difficult to assess, even when all relevant information is disclosed.’ (Arunachalam R. , CUVMF Blog, 2011b), marked as in original)

Besides, engaging in consumer protection will also make sure that the market becomes fairer for suppliers. The late Shashi Rajagopalan, Director of the Central Board of the Reserve Bank of India and member of the Malegam Committee even suggested that there might be a cartel.

‘But even competition – what is seen in the MFI sector, 4,5, MFIs can form a cartel and not come into competitive spirit, and that’s what we saw happening, and therefore it’s again very important not to assume that just because there are many players, there will be competition. The regulator has to make sure that competition is true competition and that it doesn’t fall into a cartel instead. And in this instance, cartels have been formed.’ (Rajagopalan, p.c.)

Strengthening consumer rights can also be a step in the fight against corruption. Considering that corruption is a major problem in India (The Economist, 2011) this could also be a motivation to engage in consumer protection.

‘I’ve been to a slum in Hyderabad, there the lady has passbooks of 50 clients, she’s the coordinator agent. I asked her how she survives and she said, everyone who borrows, they give me 100, 200 Rupees. There is corruption, [...] the MFIs are also promoting corruption.’ (C.S. Reddy, p.c.)

The widespread practice of the use of agents is a very severe problem, which I also address in a section on microfinance and politics in chapter 4.1.3.

None of these approaches see consumer protection as something derived from developmental goals but as ‘an ethical part of financial services’ (Access, 2011, p. 6). This strengthens the argument microfinance should be treated as any other financial service.

3.2.2. Regulatory risks

Paternalism vs. Free choice

There are also arguments against consumer protection. One is the allegation that consumer protection is paternalistic and restricts personal freedom and choice, which includes even ‘the right to choose imprudently’ (Harvey, 1978, p. 19). Others say the poor are underestimated and know better what they need than some drafters of legislation who are far away from their reality.

‘The notion that it’s somehow unethical to enter into a profitable business working with the poor is insulting to the poor. They are not children who need our protection. They’re working women and men who are thriving under a system that allows them to take their economic lives into their own hands. Treating them as anything less is unjust.’ (Akula, 2010, p. 153)

One reason for consumer protection is to safeguard that a consumer has enough information to make a choice. It is paternalistic in the sense that some contracts are unenforceable, even if the consumer would wish to be bound by them. In order to justify that paternalism, some argue using the assumption that consumers consent to the state overruling their wishes (Cartwright, 1999, p. 14). The role of consumer protection must be to ‘protect the consumer against misrepresentations of a contractual nature and to protect the prudent shopper on the basis of information. If all relevant information about a class of goods is available to the prudent shopper, together with information about the true cost [...] then at least a prudent shopping decision can be made with the consumers’ eyes full open’ (Harvey, 1978, p. 19). The right to make imprudent decision is not hindered by such measures. Everyone is free to take decisions despite knowing better. Considering the asymmetry of the contractors in microfinance, and the lack of information on one side, an institution cannot claim to treat their clients as equal partners and be non-transparent on terms and conditions of that contract at the same time. I would rather argue that consumer protection does not restrict a free informed choice here, but enables it in the first place.

High administrative costs and anti-competitive effects

Another argument is that consumer protection will increase costs that will have to be carried by the consumer.

The counter argument sees the need for a balance of the costs occurring for businesses to comply with legal provisions and the transactional costs of the consumer who has to check the product himself and is at risk to be exploited when there is no consumer protection (See Harvey, 1978, p. 22).

As a CGAP report on consumer protection argues, there is a conflict between consumer protection and keeping the costs low for clients reaching scale:

,The drive to include poor clients naturally leads banks to cost-effective technologies that make transaction costs affordable to customers and banks. Outsourcing noncore tasks is an effective way to reduce costs, but having nonbank staff handle banking transactions increases risks. When banks or regulators take steps to contain these risks, customer service tends to diminish and access to expanded services tends to become restricted by limiting the types of services nonbank staff are authorized to handle. There is a tradeoff between customer service and customer protection. Customer service tends to diminish in branchless models where there is minimal direct interaction between bank staff and the customer. Reduced customer service is reflected in a longer time needed to acquire clients because of stringent know your customer (KYC) requirements, restricted range of services, limits on transaction size, and additional safeguards for establishing customer identity that require customers to provide information such as personal identification numbers (PINs), passwords, fingerprint, etc.’ (CGAP, 2010, p. 2)

This is one reason why it is important to have a regulation applying to all market players equally. Otherwise, a single institution will suffer from a competitive disadvantage (at least in the short run). As Chuck Waterfield from Microfinance Transparency puts it: ‘The problem of keeping your price transparent is obvious – it’s difficult to show a true price that *looks* higher than the competition when, in fact, it is *lower* than that charged by others’ (Waterfield, CGAP MF Blog, 2011, marked as in original).

As costs increase for the businesses, only the biggest ones might survive. Institutions that offer new, individually shaped products, or new market entrants carry a higher risk. They have higher costs, which might be harder to carry, as their businesses are still smaller. This is a general problem of scale though. As Deepak Alok pointed out to me, these costs and regulations are part of the regulatory scheme businesses have to take into account.

‘Those costs have to be dealt with in the business plan anyways, that cannot be dealt away with, so for example, if you’re manufacturing a chemical, then you have to comply with all regulations, you have to take approval and all, so this would be kind of a business condition.

[...] Deserving candidates who want to enter, they will find ways, they will find investments, too, complying with the regulations.’ (Alok, p.c.)

3.3. The general level of consumer protection in India

‘You are educated, I’m educated, we educated people are being exploited, so how can you expect illiterate people not to be exploited.’ (C.S. Reddy , p.c.)

India passed consumer regulation as early as 1986 in a distinct law, as one of the first countries in the region. At the time it was passed – and even now — the Consumer Protection Act²⁵ was one of the most progressive acts in this regard. The act defines consumer as any person who pays for a good or service, including ‘goods bought and used by him and services availed by him exclusively for the purposes of earning his livelihood by means of self-employment’ (Para 2 (d) (ii) CPA). This means it also covers micro-entrepreneurs, the typical microfinance clients.

Consumers enjoy the rights, which are stated in para. 6 of the act. These include ‘the right to be informed’ (para. 6 (b)), ‘the right to be heard and to be assured that consumer’s interests will receive due consideration at appropriate forums’ (para. 6 (c)), ‘the right to seek redressal’ (para. 6 (e)), and ‘the right to consumer education’ (para. 6 (f)).

The administrative structure that was created in India is quite elaborate, there is a ministry dedicated to consumer affairs, the Ministry for Consumer Affairs, Food and Public Distribution. In all states there are Consumer Protection Councils, which have also been established on district level (von Braunmühl, 2010, p. 403). These institutions have the task to safeguard consumer rights and should meet regularly. In practice, these meetings are unfortunately not conducted as often as provided by the law. This makes the system rather inefficient (ibid, p. 404). For consumer complaints, there are consumer disputes redressal agencies (para. 9 CPA) on the national, state and district level. These forums consist of judges and lay members. They resemble courts as they have judicial power over complaints of consumers even though not all of their members are judges. The idea behind the establishment of these tribunals is to avoid lengthy court procedures and make jurisdiction easily available for consumers. A decision is supposed to be made within three months (para. 13 (3A) CPA).

²⁵ For a selection of relevant provision of the Consumer Protection Act, 1986 see Appendix I.

Unfortunately consumer protection in India is not as extensive and efficient in reality as it is on paper. In a recent study, none of the tribunals examined was following the rule to decide within three months, but instead took a year or more. The study was conducted in 2008 and found that there were cases pending which had been filed as early as 1992 (von Braunmühl, 2010, p. 404). It can be said that the Consumer Disputes Redressal Agencies do not manage to cater to the needs they were created for. Even though consumer protection is a concern in India, the existing mechanisms do not seem to be sufficient to safeguard consumer protection rights²⁶. These difficulties should be held in mind when designing a consumer protection framework for microfinance clients. The little awareness of clients and their limited means will further increase the difficulties of enforcement. This is why a regulatory framework for microfinance has to include all stakeholders and hold them accountable. In the next section I describe the current status of regulation on different levels and difficulties occurring with regulation of these stakeholders.

²⁶ There are efforts to improve the systems of legal redress for clients, like a GIZ project working on mediation procedures. See http://www.asemindia.com/Project_cat.aspx?Sectionid=2&Subsectionid=10&rowid=13&catid=25, retrieved August, 20th, 2011.

4. THE STATUS OF CONSUMER PROTECTION IN MICROFINANCE IN INDIA

,It's an imperfect and uncomfortable state of affairs. And every piece in the lending ecosystem is to blame.' (The Economic Times, 2010c)

,They [i.e. microfinance practitioners, author's note] knew, and we have told them time and again, that you are inviting trouble from the government and politicians by doing what they're doing and they said: to hell with you, and now, they are in a total mess, there was a mess in 2005...and they never woke up. In 2005, 06 they came up with a code of conduct, and even now, the code of conduct is not implemented. I sit on Sa-Dhans Board, and nothing happens, neither the associations feel responsible, nor the individual MFIs, [...] nor banks, which are lending, which RBI calls principle agents, they don't feel responsible. The RBI, which is supposed to be a regulator, does not feel responsible. In fact, in the Malegam Report they agreed that they have failed their duty as a regulator. The point is that none of them paid attention to client protection or responsible MF because they were basically keen to make money.' (C.S. Reddy, p.c.)

Recent events in Indian microfinance suggest that consumer protection in Indian microfinance needs improvement. There is no single culprit for the Indian microfinance crisis; rather, the events show a systematic failure. None of the stakeholders involved managed to anticipate and prevent the emergence of a bubble. In this section I discuss the present status of consumer protection at the levels of various microfinance stakeholders. Additionally, I present challenges at their respective levels. Considering the variety of players involved and their respective interests, there are many issues that I just touch briefly. To add clarity, I add a little paragraph at the end of each sub-chapter, presenting the critical issues in the context of a regulatory framework.

4.1. The State

'Regulators perceive high risks from nonbanks offering banking services, given low literacy levels and past experience with nonbank financial services provision.' (CGAP, 2010, p. 2)

As microfinance is a crosscut issue, it is uncertain which entity in the Indian federation is competent to regulate consumer protection - as was mentioned earlier. Here, regulation at the national level, the RBI and the state level will be discussed. As C.S. Reddy from APMAS noted, at one point there was discussion about the creation of a 'separate entity, called Microfinance Development and Regulation Authority, MFDRA, which could then cover all different forms', however, it was never realised due to lack of 'interest in it in the government of India level or the RBI level' (C.S. Reddy, p.c.).

4.1.1. The Indian government

As mentioned above, even at the national level there are several players that could engage in client protection in microfinance. There is – amongst others - the financial ministry, the ministry for rural development, or the ministry of consumer affairs and public distribution²⁷. The main actors at the national level have been the Ministry of Finance and the RBI. Still, as explained earlier, also other national laws like the Consumer Protection Act apply to microfinance.

a. The Micro Finance Bill 2007/2011

As mentioned above, already in 2007 a central microfinance bill was placed at the Lok Sabha, the Indian parliament, but was never passed. In 2010, there were efforts to revise the bill. As the RBI had started drafting a regulation covering NBFCs, some voices said it was unnecessary to regulate the remaining entities, especially as those were not commercial entities (Business Standard, 2011a). The bill was expected in early 2011 (Moneycontrol.com, 2010). Recent reports already indicated that the state has followed the view that the RBI regulation makes a central regulation redundant. An Indian news website quoted a Finance Ministry Official:

‘ “There is a feeling that the ground realities of the sector are now different, especially after the announcement of an MFI policy by the Reserve Bank of India early in May,” the official said. The Finance Ministry had ‘found’ overlaps in the draft Bill and the Malegam panel recommendations, which were accepted by the apex bank almost in totality [...]. “Some grounds on which the Bill has been put on hold are the caps on interest margin and rate of interest, and the redundancy of a central law when the RBI is the sole regulator for nearly 92 per cent of NBFC-MFIs,” he added.’ (The Hindu Businessline, 2011)

Alok Prasad, the CEO of MFIN, the association of Microfinance NBFCs, argued for a central regulation, as he expected that the struggle whether or not AP state law prevails over the RBI regulation could be solved by a central regulation (The Hindu Businessline, 2011). A new draft for a microfinance bill was introduced in July 2011²⁸ and will be discussed in the Indian Parliament in one of the next sessions.

The draft suggests to regulate all institutions offering microfinance (except co-operatives), and to establish the ‘Micro Finance Development Council’ as an advisor to the central government as well as to the state governments (MFI Bill 2011, para 3-9). MFIs will have to

²⁷ These acts have to be passed in parliament, so they undergo scrutiny by politicians from various fields. Still, the draft usually originates from one of the ministries.

²⁸ See Appendix.

register with the RBI (MFI Bill 2011, para 10), which has to scrutinize that certain conditions are met. Besides a minimum capital of 5 lakhs Rs., these provisions are held rather generally. There are clauses like ‘the general character and management of the applicant shall not be prejudicial to the interest of the clients availing micro finance services’ (ibid, para 12 (1) a), or that ‘the applicant is engaged in the promotion of financial inclusion by providing *micro finance services*’ (ibid, para 12 (1) b, marked as in original).

It RBI will have the duty to ‘promote and ensure orderly growth of the micro finance *Sector* in accordance with such measures as it deems fit, *for the purpose of promoting financial inclusion*’ (ibid, para 23 (1), marked as in original). In pursuit of this mandate, they are to provide i.a. for ‘greater transparency’ (ibid, para. 23 (2) a), to issue sector related benchmarks and standard measuring ‘methods of operation, measures of recovery’ (ibid, para. 23 (2) b), to collect information for a ‘data base in the public domain relating to micro finance services’ (para. 23 (2) f), and are responsible for ‘training and capacity building measures’ (ibid, para. 23 (2) g) and promotion of customer education for ‘greater awareness and for economic empowerment of micro finance clients’ (ibid, para 23 (2) h). In its mandate the RBI may also give so called ‘directions’ to MFIs, which are binding for the institutions (ibid, para. 24).

The draft suggests that institutions offering ‘financial assistance to eligible clients’ have to convey an annual interest rate to clients, including all fees and additional charges. Also powers of inspection and enforcement (ibid, para 26) are to be transferred to the RBI, which might take steps like the removal of officers or the managing committee, or prohibition of further provision of micro finance services.

The RBI is also responsible to appoint Ombudsmen in order to ensure redress of grievances by individual clients (ibid, para 31).

The provisions allowing thrift (ibid, para 44) were strongly welcomed by the microfinance industry (M-CRIL, 2011, p. 2). The whole bill is seen positive, as it declares the systematic importance of microfinance institutions for financial inclusion and might settle the constitutional dispute. The financial market shared this perception, the proposal of the new draft led to a rise of 20% of the SKS stock (IndiaRealtime, 2011).

There was criticism that the draft for the MFI Bill entails too many vague provisions and is regulating ‘micro-management’ issues of MFIs, which ‘risks leaving the regulation of the microfinance sector open to changing political winds almost in the way that the sudden

promulgation of the Andhra Pradesh legislation brought microfinance in the state to a halt' (M-CRIL, 2011, p. 3). Also the provision, which enables the RBI to transfer certain powers to NABARD led to uncertainty (ibid). NABARD itself was discussed to take up a regulatory role for non NBFC MFIs (SiliconIndia, 2010). Microfinance practitioners were worried that NABARD would struggle with objectivity, as they are also engaged in microfinance themselves in the SHG-BLP programme (Mehta Mankar, p.c.).

'If it is given a proper mandate, a proper capacity building and a proper system to enforce the regulation that it has, it may be a good regulator. RBI has an intact system of supervision and monitoring. NABARD may not have for an effective supervision. Because regulation also means to have an effective system of monitoring and supervision. So NABARD will also have to develop a monitoring wing in case it wants to monitor it. But again, NABARD regulation will have to be consistent with RBI regulation, because this is an issue, which is part of the financial sector.' (Alok, p.c.)

By having a central bill that transfers powers to RBI and allows the RBI to transfer them further to NABARD, there will be a uniform regulation, at least in the union entities.

4.1.2. The Reserve Bank of India

'It makes sense that RBI is the regulator, because they are the regulator for the financial sector, so why should MF be left out. But they cannot be regulating from the perspective of systemic risk, or the institutional protection, they should be regulating from a perspective of the client protection.' (C.S. Reddy, p.c.)

The majority of the microfinance practitioners I interviewed were of the opinion that the RBI was the best-suited regulator for microfinance, as they shared the opinion that it was a 'highly respected, careful and knowledgeable institution' (M-CRIL, 2011, p. 3). They perceive the RBI as an entity that is not influenced by daily politics.

'Not that I agree with all their regulations, but it should be a central body like the RBI, a lot of MFIs or NBFCs already come under RBI regulation. I definitely think there's value in it being an apex central body versus state level governments, because what we've seen happen also is that that ends up being simply about the politics and power play between the state governments and people who are affected by the microfinance operations.' (Mehta Mankar, p.c.)

'RBI is a very, very good regulator in that sense, thinking ahead, forming something. Sometimes they lack to take action, but some of the lack is deliberate or sometimes when they say 'Theek hai'²⁹, there might be oversight.' (Desai, p.c.)

As was explained earlier, the RBI is competent to regulate NBFCs. Someone interested in setting up an NBFC will have to apply for registration at the RBI. Its members are nominated by the Indian Government, which owns the institution. The RBI is India's central banking

²⁹ Hindi expression for 'Alright'

institution with the main mandate to safeguard monetary and financial stability. As such it also has the competence and task to regulate and supervise the banking sector, including NBFCs. Due to its systematic approach, the RBI was for a long time reluctant to pass a regulation on consumer protection.

Already in 2009, the RBI had already given out a circular on fair practices codes for NBFCs³⁰. This circular requires MFIs to adopt a fair practice code themselves and gives an outline of what this code is supposed to include. There is a duty to adopt a model for interest rates, fees and other charges, which should also be made available to the public in a newspaper and online. Interest rates are supposed to be conveyed as annualised interest rates in order to make products comparable for customers. To this end, the terms and conditions shall be expressed in clear language with the main points included in the loan application form to help the client make an informed decision. Terms and conditions should also be provided to borrowers in writing. Next to transparency, fair recovery practices were addressed. MFIs should resort from practices of harassment and physical violence in the recovery process. Furthermore, NBFCs are to put a grievance mechanism into place. (RBI, 2009). The master circular is binding and NBFCs might face sanctions if they do not act accordingly (M2i Consulting, unpublished). However, the points addressed are rather goals than real duties, since there are no benchmarks included in the document. This makes the regulation soft and easy to circumvent. Maybe it was even seen as a gesture in order to urge MFIs to retain discipline and settle the issue themselves.

As mentioned earlier, in November 2010, after the State Government of Andhra Pradesh had passed its regulation, the RBI assigned the Malegam Committee with the task to make a recommendation for a regulation on consumer protection in microfinance. In May 2011, the RBI announced in its the monetary statement that it had decided to accept the framework of these recommendations:

‘The RBI announced that after ‘the recommendations of the Committee³¹ were discussed with all stakeholders, including the Government of India, select State Governments, major NBFCs working as MFIs, industry associations of MFIs working in the country, other smaller MFIs, and major banks’, it would ‘accept the broad framework of regulations recommended by the Committee’ (RBI, 2011b).

³⁰ Available at http://rbidocs.rbi.org.in/rdocs/notification/PDFs/15FAPRCO_010709.pdf . Retrieved February 20th, 2011.

The role that has been assigned to the RBI in the draft of the new microfinance bill has been discussed in the previous chapter. As it transfers a lot of regulatory and supervisory functions to the RBI the recommendations of the Malegam Committee might remain as they are, when the Microfinance Bill will be adopted by parliament.

The Recommendations of the Malegam Committee³²

‘[...] We are very clear that, for the first time, the RBI is not only looking at regulation for the sake of systemic good management, for the first time we are saying, regulation for the sake of the consumer, the customer. We have not done it before, so we are suggesting that for the first time. And I certainly believe that a very good code will develop as a result.’ (Personal communication.’ (Rajagopalan, p.c.)

Detailed guidelines are yet to be published, but as of now, the main suggestions are the following³³:

The Malegam Committee suggested introducing a new category of NBFC-MFIs. By the preliminary definition, an NBFC-MFI is

‘A company (other than a company licensed under Section 25 of the Companies Act, 1956) which provides financial services pre-dominantly to low-income borrowers with loans of small amounts, for short-terms, on unsecured basis, mainly for income-generating activities, with repayment schedules which are more frequent than those normally stipulated by commercial banks and which further conforms to the regulations specified in that behalf’ (RBI, 2011a, p. para 4.2).

Bank loans to MFIs ‘will be eligible for classification as priority sector loans under respective category of indirect finance only if the prescribed percentage of their total assets are in the nature of "qualifying assets" and they adhere to the "pricing of interest" guidelines to be issued in this regard’ (RBI, 2011b, para 92). ‘Qualifying asset’ means that it has to meet the following criteria:

,(i)³⁴ loan disbursed by an MFI to a borrower with a rural household annual income not exceeding ` 60,000 or urban and semi-urban household income not exceeding ` 1,20,000; (ii)³⁵ loan amount not to exceed ` 35,000 in the first cycle and ` 50,000 in subsequent cycles; (iii)

³² As already noted, the RBI has announced that it will pass the framework of the recommendations, and already announced some revised provisions RBI. (2011, para. 92). I will present the revised versions where they exist and indicate it in a footnote.

³³ For a summary and a selection of relevant provisions see appendix

³⁴ In the Malegam Report, there was a unified maximal household income of 50,000 Rupees. After discussions with stakeholders, the different livelihood of urban clients was factored in. (RBI, 2011, para. 5.9.)

³⁵ In the Malegam Report, there was a unified maximum loan size of 25,000 Rupees. (ibid.)

total indebtedness of the borrower not to exceed ` 50,000; (iv) tenure of loan not to be less than 24 months for loan amount in excess of ` 15,000 without prepayment penalty; (iv) loan to be extended without collateral; (v) aggregate amount of loan, given for income generation, not to be less than 75 per cent of the total loans given by the MFIs; and (vi) loan to be repayable by weekly, fortnightly or monthly instalments at the choice of the borrower' (RBI, 2011b, para. 92)

The Malegam Committee suggested regulating transparency in loan pricing (RBI, 2011a, para 8.7), so that MFIs shall only charge a processing fee, an interest charge and an insurance premium. Effective interest rates shall be displayed in offices and loan documents (ibid, para 8). Not more than two MFIs shall lend to an individual borrower (ibid, para 9.7). MFIs may lend to individuals outside JLGs or SHGs (RBI, 2011b, para 92)³⁶.

The Report foresees the creation of one or more credit information bureaus (RBI, 2011a, para 10.5).

Additionally, in order to ensure enforcement of the provisions, it proposes to establish a proper system of grievance redress by MFIs (ibid, para 11.9).

In order to 'widen the base from which MFIs are funded in respect of the Net Owned Funds needed for Capital Adequacy', the committee suggests to create one or more 'social capital funds' (ibid, para 21).

Additionally, the RBI introduced a margin cap of 12% and interest rate cap of 26% on individual loans in order to be eligible as priority sector loans (RBI, 2011b, p. para 92).

As the draft for the MF Bill foresees that the RBI will take up a regulatory role - including consumer protection issues, it is likely to become the main regulator. Some aspects of this new role are still unclear. To name one, there are doubts about the RBIs power to monitor and enforce this regulation.

, While aspects related to Corporate Governance, Systems and other such aspects for NBFC MFIs are non-negotiables and need to be solidly enforced through a regulatory stipulation and also supervised diligently, the aspect of artificially restricting client level of borrowing, placing emphasis on the household income as an eligibility criterion and such aspects are practically untenable. As someone who has worked in over 550 districts in India and several other countries over the last 23 years, I can vouch safe that such measures cannot be enforced on the ground. And also, as these aspects cannot be supervised with any degree of reliability, they should not be regulated at all. And if this still needs to be done, it may be better to influence these by incentivising the appropriate behaviors through provision of preferential priority sector credit (and/or other incentives) for livelihood loans, loans lesser than Rs 50000 and the

³⁶ In contrast to para 9.7 of the Malegam Report where it says that 'MFIs should lend to an individual borrower only as a member of a JLG'.

like.’ (Arunachalam R. , CUVMF Blog, 2011c)

4.1.3. The federal States

After the regulatory action of the AP government³⁷, a claim frequently made was that the act was politically motivated. Many fear giving power to state governments in this aspect, as they are conceived to be driven by short-term political considerations.

As this is a general topic and not confined to the states I insert a brief excursus on the topic.

Excursus: Microfinance and politics

‘What do you think has happened in AP? It’s political business. It’s a huge vote-bank at the end of the day.’ (Practitioner 3, p.c.)

One risk that people see in the states being regulators for the microfinance sector is the fear of populist action by political parties. The poor are seen as ‘vote-banks’ who will give their votes to the party promising them a loan waiver.

‘There is political risk; the microfinance clientele belongs to the bottom of the socioeconomic pyramid. India is a democracy and we elect our leaders, as a result populist policies and programs are announced including tinkering with the regulation, loan waivers and subsidies’ (Arya, p.c.).

‘The only thing is, they shouldn’t be seen as a political victory. This is the end. If the congress, which is leading in AP, if they see that killing of microfinance in AP is a victory for them, then the sector is finished. [...] The new chief minister came, and he announced he’s against MFIs. [...] If the congress sees it as a victory, and as winning a vote-bank, then that’s the end of the sector. Because then everybody else will replicate, and if there’s an opposition, they will do it faster than the congress. Without getting into politics, as an economic disaster or issue, if you can take it and solve it, I think we’re better off.’ (Ramana, p.c.)

That political parties try to gain popularity by criticising microfinance certainly holds true. As an example, after the outbreak of the crisis in Andhra Pradesh, the opposition in Andhra Pradesh instantly argued that Rahul Gandhi, member of congress, the political party in power, had a ‘proximity’ to MFIs and was to blame (Financial Express, 2010). The microfinance crisis offered a stage for politicians to show their commitment for the common man.

³⁷ For the contents of the AP Act see Appendix and Chapter 2.4.4.

For the question of constitutional powers of regulation and if the AP act will ‘survive’ see chapter 2.3.1.

Another argument is that politicians act against microfinance, as they feel threatened by the empowering effect of it. It was argued that as empowered borrowers might become independent of their political patrons, local politicians try to work against MFIs.

‘We need a regulatory regime that checks malpractices while encouraging the positive aspects of microfinance. But local politicians don’t want to empower people through independent access to finance: they prefer patronage networks that can be used as vote banks. Government-driven SHGs can serve that purpose, but not MFIs.’(The Times of India, 2010a)

Deepak Alok argued that Microfinance products replace dependency on grants given by local politicians. These grants were given in anticipation of votes.

‘Poor people are also a political constituency. And lots of women grants and other grants are directed towards the poor. And lots of people expect votes in return for that. So, if something is going with them without those sources that may create a competition. Definitely this is a political risk. (Alok, p.c.)

The abuse of microfinance for local politics is striking in the widespread use of local politicians as agents. In one instance, the agent collected commission for loans, which were only disbursed after the local elections (Arunachalam R. , CUVMF Blog, 2011d).

Another argument condemning the action of the state explained the act as an unfair means in a competitive situation. As a provider of the SHG-BLP, the state was acting to gain a competitive advantage. This claim stems from MFIs being attacked as undermining the goal of state sponsored programmes like NREGA. MFIs were accused of siphoning up funds, which the poor had previously received from the state.

‘NREGA is a state sponsored employment generation programme, assuring wage labour at a specified wage rate. It is intended to be a poverty alleviation programme. Such payments on a weekly basis are being used to repay the high cost loans from MFIs, or siphoned off by MFIs. This has negated the very purpose of such programmes.’ (Practitioner 1, p.c.)

While state officials see their projects under attack, MFI officials claim that clients chose MFI loans over SHG loans as they are easier and faster to avail and the AP government is using its political power to strengthen its position in this competitive situation.

‘The AP government says it is protecting borrowers from coercive loan recovery by MFIs that reportedly has caused 30 suicides. Its not-so-hidden agenda is to give the government’s own microfinance scheme — through self help groups (SHGs) — a lending monopoly, eliminating MFI rivals. The preamble of the ordinance clearly says that MFIs are a threat to SHGs and must be quashed.

The government is supposed to be a referee. But in AP, the referee is also a big player and it wins by disqualifying rivals. The state alone cannot provide enough inclusive finance, so villagers will be driven back to moneylenders. Money lending thugs posing as MFIs have apparently caused some suicides.’ (The Times of India, 2010a)

‘Behind the scenes, the AP Act was written and championed by SERP, the agency responsible for running the AP government-backed microfinance SHG program. Evidence shows that SERP has been losing the struggle to compete with private sector MFIs.

The effect of the AP Act is not to protect the poor, but to protect the uncompetitive government-backed SHG program run by SERP.

The AP government-backed SHG program competes directly with the private sector MFIs. The SHG program however is failing to keep up and has lost significant market share to the MFIs. Why? According to the October 2010 Intelicap White Paper, the government programs have “...neither the discipline needed for long-term sustainability, nor a business model that can be scaled up effectively”. Additionally, there is a widespread belief that the World Bank is on the point of providing an additional \$1 billion in funding support to SERP or a successor program. The case for this extension is believed to be strengthened if the commercial MFI industry is weakened.

An AP Act that eliminates law-abiding private sector participants in the market and directly benefits the government-backed provider is unfair at best and illegal at worst.’ (Legatum Ventures, 2011, p. 5)

‘I think the AP crisis is nothing but a public-private conflict where the state has its own programme and the private initiatives seem to be growing much faster on the back of (primarily) foreign commercial capital [...]. Nobody can compete with the state when it comes to it, your state has several powers and private initiatives can’t do anything about it. I think it is specifically that. The fact that the MFI community, in their pursuit of growth, also overlooked issues regarding what was happening to their customers, didn’t help the cause.’ (Shrivastava, p.c.)

MFI stakeholders are uncomfortable to have the state governments involved as its actions are conceived as being harder to predict. In Andhra Pradesh, the MFIs seemed to be surprised by the action of the AP government (e.g. Practitioner 3, p.c.). Considering the earlier crises of microfinance and the coverage in Indian literature and media in the last years this argument is a little surprising. SERP claimed that they tried to discuss the matter with stakeholders and enacted the ordinance, as discussions did not lead to any change.

‘The practices of the MFI were not healthy and many of them were aware of the impending problems. However, with a view to expand rapidly and to earn more for the purpose, all basic tenets of financing have been given a go by driving the poor into debt trap. The ordinance has not just come like that and all the concerned have been sounded about the problems before the ordinance was brought into effect.’ (Practitioner 1, p.c.)

That regulation was passed as an ordinance initially, and not as a parliamentary act right away, does give the impression that the actual adoption was quite sudden. Regardless of the circumstances surrounding the issuing of the ordinance, it is hard to believe that MFIs were

surprised by the state taking action - given the previous crises happening in Indian microfinance.

‘I was not following the developments there and most of the developments in AP happened in regional media, that almost for eight to nine months before the crisis erupted there were signs in the media, some sporadic news coming here and there, so that way MFI had significant time and signals to do corrective actions, that they have not done. Managing the bureaucracy, managing the political risk and managing the media risks, on these three accounts they have failed miserably. Rather, they have antagonized all these three forces, not even kept it neutral.’ (Practitioner 2, p.c.)

‘The funny thing in MF in India is, everybody is worried about MFIs, but MFIs are not worried about themselves [...]. From 2003 onwards, even if you see the NABARD report of 99, every time there has been a mention about the need to be responsible, not having a mission drift, there was the example of Compartamos having a public issue. Every workshop, conference, meeting said MFIs should not undercut each other, there should not be unhealthy competition, they should improve governance, all the rating reports raised these issues.’ (C.S. Reddy, p.c.)

While regulation by a central authority such as the national State or the RBI certainly is needed to create an equal playing field, it will be hard for such an entity to supervise the implementation on the ground level, especially concerning consumer protection, as Ramesh Arunachalam argued:

‘If we rely on the RBI or a central institution (without local presence) to deliver the goods on the above consumer protection aspects, it would be analogous to searching for a needle in a haystack. [...] Without question, these aspects cannot be monitored and set right by the central bank, or any other national institution, or MFI association, as they do not have the local presence and resources. It did not happen last time around and it will not happen now. This can only be done by the state governments and them alone. And if such issues are brushed aside and the proposed microfinance bill is unable to prevent occurrence of these and similar problems, the microfinance crisis will reappear again and in much larger vein all over India.’ (Arunachalam R. , moneylife, 2011)

Action of the AP government was to be expected, given the events of the years before and corresponding announcements, which were ignored by MFIs. That a regulator stepped in was certainly needed. This would have been the time for the central regulator to finally adopt a unified microfinance bill to regulate the sector coherently and nationwide. Following the draft of the MFI bill, the RBI will become the regulator for the sector. This was welcomed by the sector, as the RBI is a trusted and knowledgeable institution. As long as the bill is not passed, however, there is uncertainty of the regulatory situation. In such an ambiguous environment, banks and investors have stopped lending to MFIs. The longer the wait for regulatory action continues, the more MFIs will have to close down (see e.g. livemint, 2011) To have institutions that provide microfinance services in a regulated environment would certainly be the better option.

4.2. Funders' Responsibility

‘As long as money comes, nobody bothers’ (Ramana, p.c.)

When discussing responsibility for the crisis in microfinance, the role of microfinance funders cannot be left out. Funders were blamed for not having scrutinized the MFIs they were investing in, and for pushing them to meet unrealistic growth rates. It was argued that ‘MFIs are expected to achieve 100 % repayment rate by funders and investors, knowing fully well that such recovery rates are achieved only by causing the customers acute distress’ (Access, 2011).

As funders are in control of the capital that institutions need they have a strong position and would be able to expect consumer protection as a loan conditionality. That way they could strengthen the awareness and importance of client protection easily.

The lending institutions differ in what they expect from their investment. Initially it was merely donors and social investors who lent, expecting poverty reduction and other developmental benchmarks to improve. Then banks came in, which were happy to fulfil their PSL quota in an easy and profitable way. In the last step, equity investors realized that microfinance was a profitable business model and invested to get high returns. As it is hard for the Indian regulator to govern funders, especially donors and investors, other mechanisms are relevant to ensure consumer protection. In this section I will briefly describe these funders and current efforts to regulate their behaviour.

4.2.1. Donors

‘DFID and other donors must play a central part in refocusing the industry. As Mark Napier, the incoming Director of Investment Innovation at CDC stated during an oral evidence session for this inquiry, donors should act as the ‘conscience of the market.’ (APPG, 2011a, p. 6)

Next to the Indian state and Indian institutions like SIDBI (Small Industries Development Bank of India) or NABARD, international donors provide finance to MFIs. These institutions are known as ‘patient lenders’, who have lower expectation for returns but see microfinance as a means to achieve goals in their development policy. Because of this strong non-financial motivation for their involvement they should be expected to be especially diligent concerning the situation of consumers.

The World Bank and SIDBI have started a ‘responsible microfinance’ project³⁸, in which they have developed ‘a framework of ‘good practice’ based policies for the sector. These set of policies are handed to the sector through loan conditionalities arising from its loan to SIDBI, which in turn would be providing bulk funds to MFIs (Srinivasan N., SSR 2010, p. 84). Institutions approaching SIDBI for funding will have to share their data on an information platform. The institutions will be monitored on the implementation of their codes of conduct and their client relations. As of now, four of these reports are publicly available online³⁹. These reports are very valuable as they provide a social rating and try to measure the development impact of MFIs. These ratings can be used for donors or other investors to check that institutions they are funding have an impact on social parameters.⁴⁰

Donors are mainly funding the SHG-BLP, and no commercial microfinance operations. It has received contributions by ‘virtually every bilateral, multilateral agency, and private foundation in the country, including agencies within the UN system [...] multilaterals outside it like the world bank, and government agencies’ (Ghate, 2007, p. 190). However, the role they played in the development of commercial microfinance should not be forgotten. Many of the biggest MFIs started as NGOs, which were being funded by donors and private foundations (Ghate, 2007, p. 191). Ghate mentions DFID and SDC here, who enabled the transformation of NGOs to for profit entities.

‘Thus the NGOs would actually give a grant to their individual borrowers – who in turn would then invest in the shares of the new for-profit NBFC. The grant to the individual borrowers could be justified in law as having provided financial support to the poor, who were loyal customers/borrowers of the microfinance operations.

With the donor community, this could be justified as integrating the poor in the exciting investment opportunity in their own financial institution which could operate on market principles. Thus even public institutions like SIDBI – possibly in good faith – joined the game by providing transformation loans at fairly low rates of interest. These loans would provide the NGOs necessary liquidity to actually put the money in the hands of the borrowers, who in turn would invest in the NBFC, and the NBFC in turn would buy the portfolio of the NGO for cash and this cash would be used to repay the transformation loan.’ (Sriram, 2010, p. 14f)

Besides this, donors have mainly supported financial infrastructure, capacity building, and encouraged to set up industry associations like Sa-Dhan (Ghate, 2007, p. 191).

³⁸ For details see <http://www.sidbi.in/Micro/WorldBankInitiative.htm>, retrieved February 20th, 2011

³⁹ <http://www.sidbi.in/Micro/codeofconduct.html>, retrieved February 20th, 2011.

⁴⁰ For further information on social ratings see EDA, M-CRIL et.al, 2006. Social Rating and Social Performance Reporting in Microfinance. Retrieved February 20th, 2011 from <http://www.m-cril.com/pdf/Framework-for-Social-Performance-Rating-and-Reporting.pdf>.

Funders seem to be in a good position to put pressure on institutions to enact consumer protection. But aid agencies can also come under pressure themselves, by their governments and parliaments. In Germany, which is the biggest state actor in microfinance and engaged in 213 microfinance projects in 70 countries (Deutscher Bundestag, 2011), the engagement of the German government in India and its involvement in microfinance, especially in Andhra Pradesh was subject to a parliamentary inquiry by the green fraction. They scrutinized the focus of the German government in ensuring that development goals are met in its microfinance operations (ibid, question 9). They asked about the involvement of merely commercial investors who are not aiming at a positive effect for development, and about transparency for the Indian consumer (ibid, question 24). Other questions were regarding the assistance of MFIs, which were listed at the stock market (ibid, question 10), or if clients of any MFI which was given assistance by the German government had committed suicides (ibid, question 7).

In the UK, the all-parliamentary group on microfinance undertook ‘an inquiry into the role of microfinance in tackling extreme poverty and the way in which donors such as the UK Government should seek to contribute to the microfinance field’ (APPG on Microfinance, 2011b). The results were published and presented at the House of Commons. Before the inquiry was made, the topic was discussed at various occasions. One of the questions in November 2010 was ‘To ask Her Majesty's Government how they can protect the beneficiaries of United Kingdom-supported microfinance projects in south Asia from exploitation by banks and investment companies’ (UK Parliament Website, 2010). Also in the UK, the eventual funding for institutions having undergone an IPO was examined (ibid).

The public interest in the effects of government support in microfinance has led to scrutiny within the donor countries, which might have an impact on donor behaviour.

As most funders focus on supporting infrastructure and not institutions directly, they might not have the possibility to pressurize MFIs to change their behaviour on the ground. Via their engagement in industry associations and the like, however, they can raise awareness and work towards more transparency, as GIZ is doing with its engagement in enhancing consumer protection for microfinance clients.

4.2.2. (Indian) commercial Banks

‘[An, author’s note] Associated factor is the role of banks in providing teeth to industry associations and affirmative action on implementing CoCs [Codes of Conduct, author’s note].

Until banks show active interest in assuring compliance through better lending terms, the associations will not be able to operate proactively.’ (Access, 2011, p. 12)

As already mentioned, Indian banks can fulfil their Priority Sector Lending obligations by lending to MFIs. Future regulations might change the interpretation of lending to MFIs as PSL.

So far the banks have not shown particular scrutiny regarding client protection. A lenders’ forum was established, which is supposed to ‘promote transparent, responsible and commercially sustainable industry practices and codes of conduct so as to better safeguard the interests of the poor and the unbanked who form their client base’ (India Microfinance Business News, 2010). Members are banks, which account for approximately 80% of microfinance lending (ibid). The lenders forum was also involved in the ‘responsible microfinance project’ of the World Bank and SIDBI.

Still, at least in my interviews I had the impression that banks were more focussed on the profitable side of microfinance rather than looking at the success in various developmental parameters.

Q: ‘As a bank who allocated their funds to MFIs, how do you decide what MFIs will get funding? What do you look at?’

A: Generally we’re giving them a credit facility so we need to evaluate them. Qualitatively and quantitatively, when it comes to qualitative factors, the management team, a vision, a mission, the products and services they offer, the human resource capabilities, the operations and technology and when it comes to the quantitative we look at the financials, the strength of the balance sheet, how leveraged are they, what is the operative costs they show, that’s standard. Every bank revises their own matrix to evaluate MFIs and filter MFIs and then every bank parallelly devices its own portfolio strategy, what kind of MFIs would I like to lend to, so this exercise is usually done periodically and this is the programme under which we’ll be lending wholesale to MFIs. So a MFI should be x years old, it should have a minimum capital of so and so it should have promoters who are so and so some with development experience etc. That is done after a thorough analysis of the market, who are the players and a market mapping exercise and then we define our own criteria.

Q: But you don’t so much include impact and social goals but more the financial data?

A: A lot of the things for us are difficult to evaluate, so a lot of the things are taken as what they have stated and we have no reason to doubt that what they have states is going to be true. So we look for good management teams, a good board of directors, good corporate governance and if they are saying certain things like, ‘we are here to empower poor women in a certain district’ we would need to have a great reason to doubt that.’ (Arya, p.c.)

Banks have slowed down their lending significantly following the crisis in AP. It was suggested that banks should also show their effort in consumer protection by granting better lending terms to MFIs, which follow consumer protection practices at (Access, 2011, p. 12).

Besides their role in scrutinising MFIs that they provide wholesale lending to, banks could also improve the situation by lending to clients directly. The Economic Times quoted a woman asking ‘If Banks lent us enough, why would we borrow from MFIs?’ (The Economic Times, 2010c). They also quote a SERP official who argues that banks do not lend SHGs the amount they would be entitled to. Banks are not only able to provide loans at lower interest rates, but are also institutions that are trusted more and would be preferred by borrowers (Practitioner 2, p.c.).

The involvement of banks in microfinance was triggered by a regulatory obligation to assign credit to the so-called PSL. When regulating the sector, similar incentives can be used to govern the investment of banks. One option would be to require that a certain percentage of the banks’ credit should be delivered directly by banks and not through MFIs. Another option would be to require the bank to check the MFIs they lend to more closely.

4.2.3. Investors

Equity investments in India have risen significantly from 2007 onwards in the last five years (Arunachalam R. , CUVMF Blog, 2010). Roughly, they can be divided in two groups: Social, often philanthropic investors, who are said to be more patient and to expect less growth, and conventional private equity investors like Sequoia, George Soros or Vinod Khosla.

While social investors are perceived to rather resemble donors in their objectives, mainstream equity investors usually treat their investments in MF no different than their other investments.

‘You may have GTZ investing in some MFI that will be really patient capital and that will be happy with a nominal rate of return, but when a conventional investor comes in, let’s say a hedge fund, they would benchmark this investment with other investments. So if there’s 40% he would get in an investment A, he would want that 40% from Microfinance also. We talked to MFIs, they had investments from conventional hedge funds, and once you have that, there are numbers which have been promised at the time of raising the investment, there are benchmarks to be met.’ (Arya, p.c.)

‘See conventional investors are looking for return, so if your business can generate that return, they would be interested, and if there is some good which is happening that will be the icing on the cake.’ (Arya, p.c.)

‘I did ask this to very senior investors: Do you at least have 5% of your funds, which can give you 15, 16 %?’ Then they say: ‘my promoter he has a very charitable mind, but when it comes to spreadsheets, there is nothing less than 35, 36%, they don’t invest.’ But that’s what they’ve been told, that animal was grown like that. If that animal wants to come into development, this

is what will happen' (Ramana, p.c.)

Even though MFIs claim that investors and their growth expectations have no influence on the behaviour of the management, I find it hard to believe that there is really no influence and conflict among the board as the Managing Director of Sequoia argued:

'There is this outside perception that there is a conflict among the board. But there really isn't. If you were to attend one of our board meetings, I can tell you I am just as concerned about service quality as a social investor. There really hasn't been this big social versus profit debate. In practice it has been a non-issue.' (Chadha in Microfinance Insights, 2009, p. 15)

Some of my interview partners however did see a conflict of interest between investors and the management:

'It depends on every investors mandate, there are short term and long term investors, there may be some investors which came into an MFI going for an IPO they want to enter two months before the IPO and exit post the IPO, make their 20% and go. So it really depends on the activity the MFI does. The investor is like the part owner, so they would be the driving force, how things would happen, so they would absolutely be in the position to influence the management, they're owners, right?' (Arya, p.c.)

Certainly some boards are stronger than others, and would not allow someone to invest in their MFI without clarity about the importance of social versus financial profit. In other cases, the discussion might not even take place, as those favouring greater social return over financial return have left the institution.

Alok Prasad, CEO of MFIN stressed the role investors played in the Andhra Pradesh crisis at the Responsible Finance Forum

'Alok urged investors to do their part now to build a financing "eco-system" that will produce more responsible behavior in India and elsewhere. He advocated investor action on six fronts:

- As foreign investors, you must be "engaged owners, not just sleeping partners." The industry needs active governance, especially around the decisions that affect client welfare.
- Do your due diligence. You can't just fly into India on Monday, review the CEO's projections, meet some senior staff and fly home on Thursday. You need to ask hard questions and counsel the promoters. Seventy percent this year and 150% the next? No sector can sustain or manage this kind of growth.
- Insist on compliance with the industry code of conduct. It's not enough for the network to say "come on, guys, let's do the responsible thing." Bank loan covenants should address this, and other investors have influence too.
- Get regular feedback from the networks. Is your MFI partner a member in good standing of MFIN? Maybe you should urge the networks to do annual certification.
- Really integrate social performance indicators into your investment decision making processes.' (McKee et. al., CGAP MF Blog, 2011)

While 13% of PRI signatories invested in microfinance funds (PRI, 2011c, p. 17), as of now, the importance of the initiative in India is limited. While investors are certainly responsible for the way microfinance is conducted, they are hard to monitor and regulate. Investors often underlie different jurisdictions. Considering these difficulties, self-regulation is a promising approach.

Just like the lenders' forum for banks, there have also been efforts to create a voice of investors on responsible finance. The 'Principles for Responsible Investment' is an 'investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact' (PRI, 2011a). By July 2011, 920 asset owners, investment managers and service providers had signed up for the PRI (PRI, 2011b, p. 3).

'Signatories to the Principles acknowledge that poorer clients are often disadvantaged by asymmetries in financial knowledge, power, and influence. By signing the principles, investors state their commitment to fair treatment and protection of the interests of the ultimate client in inclusive finance – low-income households and small and medium-enterprises. Signatories assert their goal of supporting and investing in those financial service institutions that offer responsible micro-finance, including a wide range of quality services to clients. They embrace transparency and sustainability.' (India Microfinance Business News, 2011)

While funders are diverse and often not governed by Indian law, there are other methods of inducing them to respect consumers' rights. Donors for instance, are increasingly scrutinised by parliaments in their home countries. Banks and investors have started engaging in self-regulatory efforts. These also address the responsible use of the strong negotiating power of funding. It enables funders to enforce consumer protection by demanding it from MFIs.

Other stakeholders, besides investors, are also engaged in self-regulation, especially industry associations. In the next chapter I explain the concept of self-regulation and describe current efforts.

4.3. Self-Regulation by Industry Bodies

'In the absence of any other regulation, self regulation is a start' (Ramana, p.c.)

In the last years - before the Indian State started engaging in a microfinance regulation - several industry bodies introduced codes of conduct they aimed to adhere to. Previous to the development of a body of 'hard law' came various efforts of 'soft law' in the form of self-regulation. Rosenberg defines self-regulation as 'regulation (and/or supervision) by some body that is effectively controlled by the regulated entities' (Rosenberg, 2003, p. 104). It may cover rulemaking, monitoring and sanctioning implementation, and mechanisms of legal

redress (ECLG, 2001, p. 2). All or one of them can involve soft law mechanisms. The state can also support soft law provisions by legislation, for instance when soft law supplements or substitutes for traditional regulation (ibid, p.3). Often the industry develops codes 'in anticipation of legislation if it does not do so' (ibid, p.5). The same holds true for India:

In 2006 Sa-Dhan issued their code of conduct, which addressed issues of client protection. MFIN followed in 2010. On a global scale, in 2008 CGAP and ACCION started working on 'the Smart Campaign' to endorse client protection. As mentioned above, during the same time public bodies started to criticize MFIs and to announce regulation of the sector. At the end of 2010, the State of Andhra Pradesh released its ordinance. The central government is still working on its regulation.

The benefits of self-regulation are that it is supposedly faster, more flexible and more adequate than traditional legislation. Also, the costs of implementation are alleged to be lower (ibid, p.4).

'The cost of supervision is very high for all the MFIs as their number is very high, so self-regulation for a segment of MFIs to some extent will help' (Practitioner 1, p.c.)

Still, the success of self-regulation for financial institutions is limited, as Rosenberg argues:

'Self-regulation of non-bank financial intermediaries in developing countries has been tried many times, and has virtually never been effective in protecting the soundness of the regulated organizations.' (Rosenberg, 2003, p. 104).

Also most of the microfinance practitioners I interviewed were critical about the capacity of the sector to regulate itself without having an additional regulatory framework by the legislator.

One reason for their reluctance towards self-regulation is the profit orientation of the microfinance industry, as engaging in consumer protection will come at the cost of lower profits:

'My feeling is, self-regulation is a hoax, especially when you're talking about for profit. In a for profit system, how can you expect self-regulation to take place.' (C.S. Reddy, p.c.)

Criticism increases due to the weak position microfinance customers are in. It is an area with a risk that 'unfair advantage is taken of people vulnerable for a variety of reasons'. Regulation here should safeguard values 'beyond the collective interests of individual consumers', which 'soft law alone cannot guarantee' (ECLG, 2001, p. 7).

‘Personally, I’m not a believer of self-regulation. I do not believe that self-regulation is to be depended on by any regulator, especially when it comes to fields in which the consumer is at a particular disadvantage as it is in the case of microfinance; By and large they are women borrowers, by and large they are illiterate borrowers, by and large they are people with very low bargaining power and in such cases, if the service provider wants to engage in self-regulation, so be it, but for a regulator to depend on that is not acceptable in my opinion.’ (Rajagopalan, p.c.)

What should be noted in this context is the lack of commitment by consumer organisations, which rather serve and represent middle class consumers than lobbying for poor ones. They could raise concerns publicly in order to establish a balance of interests, which is seen as critical for regulation (ECLG, 2001, p. 17).

I now discuss client protection efforts by a global campaign and by the two biggest Indian industry associations.

4.3.1. The Smart Campaign

The Smart Campaign, which was initiated by CGAP and ACCION, is a ‘global and diverse coalition of microfinance institutions, networks, associations, and other professionals working within the microfinance industry [...] serving as an umbrella for all industry-wide efforts on client protection’ (The Smart Campaign, 2011a).

It developed seven client protection principles (The Smart Campaign, 2011a), which should be followed by its endorsers. These are:

- Appropriate product design and delivery,
- Prevention of over-indebtedness,
- Transparency,
- Responsible pricing,
- Fair and respectful treatment of clients,
- Privacy of client data,
- Mechanisms for complaint resolution

Additionally, it developed tools to help MFIs to assess their client protection practices and implement the above principles. It also serves as a platform for MFIs to share their client protection training kits for field staff. In order to make adherence to the code visible, the Smart Campaign introduced a certification programme. It should help MFIs to prove their commitment to client protection and is currently getting tested in the field. It will be launched in 2012 (The Smart Campaign, 2011b).

By September 2011, the Smart Campaign was endorsed by 669 MFIs, 128 investors and donors, 109 networks, 147 supporting organizations, and over 1100 individuals (The Smart Campaign, 2011b). Due to its global coverage and representation the Smart Campaign certainly manages to raise awareness and to facilitate communication between microfinance practitioners from different cultural and methodological backgrounds. It reaches investors as well as service providers and interested individuals. It facilitates exchange between practitioners who share their tools to ensure the provision of microfinance. However, as a voluntary code, it cannot replace regulation. Self-regulatory approaches to consumer protection established at the industry level should only be a complementary tool to laws and regulations.

‘Self-regulation tools such as codes of conduct are more likely to be effective when they function in tandem with government regulation and have mechanisms to ensure adherence by participating financial institutions. In the UK for example, the consumer protection system fosters industry commitments to responsible finance through a well-defined and complementary system of regulation and self-regulation. This system articulates the roles of government, banking sector, and an independent verification board.’ (Responsible Finance Forum, 2011, p. 8)

While building up pressure to comply with standards and spreading them among investors and donors, self-regulation does not provide appropriate protection to the individual consumer, as institutions can arbitrarily choose if they wish to comply with standards. The introduction of a certificate for institutions that do comply can be a way to help clients in the competitive microfinance market to choose responsible institutions. Still, in order to strengthen the bargaining power of clients, they need to know about the certificate. Additionally, there is a risk of abuse of such a certificate, or the possibility of fraudulent acquisition of it.

4.3.2. Indian Industry Associations

‘The requirement for self-regulation is self-control’ (Practitioner 1, p.c.)

The report of the Malegam Committee stressed the importance of industry associations and acknowledged their work. The Committee saw a role for the associations in ensuring compliance with the RBI regulation within their members:

‘(a) Industry associations must also assume greater responsibility in ensuring compliance. A possible scheme which may be considered would be as under:
[...]

- ii. The association will have a code of conduct in accordance with the Client Protection Code as stipulated by the Regulator.
- iii. The association will have an Enforcement Committee to check violations of the Code brought to its attention by its own inspection system or by outsiders including the State Government and the Regulator.
- iv. The association will discipline its members by removing them from membership if there is persistent violation of the Code and will publicise the fact of removal
- v. The members will publicly acknowledge their membership of the association in their letter heads and in all their communications.
- b) If the above steps are effectively implemented, membership of these associations will be seen by the trade, borrowers and lenders as a mark of confidence and removal from membership can have adverse reputational impact. This can be a major deterrent to non-compliance.
- c) There are also other organisations in the trade which cover other functions like data gathering, assist development NGOs, etc. These can act as “whistle blowers” to highlight violations of the regulations or the Code of Conduct.’ (RBI, 2011a, para 22.4)

Already earlier, Indian industry associations had introduced their own codes of conduct. There are several industry associations of different sizes in the Indian market like, AKMI for MFIs in Karnataka. These are not discussed here as I focus on the two nationwide organizations, Sa-Dhan and MFIN.

a. Sa-Dhan

Sa-Dhan is the largest Indian microfinance association. Its members are commercial and not for profit MFIs as well as associations, capacity building organisations and lenders. Established in 1999, it currently has 251 members (Sa-Dhan, 2011a). Sa-Dhan works in the areas of policy intervention, the setting of standards and capacity building (Sa-Dhan, 2011b).

Sa-Dhan introduced its code of conduct in the beginning of 2007 on a voluntary basis. It was strengthened and refined subsequently. In 2010, in the wake of increasing criticism of rogue practices on the ground ‘additional provisions to make implementation of the code imperative’ and ‘penal provisions against indifferent members’ were added (Sa-Dhan, 2011c, p. 13). A subcommittee on the Code of Conduct was formed. By using international codes, like the Smart Campaign Client Protection Principles and with consultation of the RBI and SIDBI, with lenders and the Ministries of Finance and Rural Development the code was released and adopted in August 2010. In September, Sa-Dhan started to collect data on the implementation (Sa-Dhan, 2011c, p. 14).

Sa-Dhan’s Code of Conduct contains three parts. The first one is on ‘core values in microfinance’, the second one contains the actual code of conduct and the third part provides

for a compliance mechanism. While the code of conduct is formulated using a lot of undefined and vague terms (e.g.: ‘design appropriate policies’, ‘committed to follow fair practices built on dignity, respect, fair treatment, persuasion and courtesy to the clients’, ‘observe high standards on governance’), Sa-Dhan formulated indicators to measure social performance and adherence to the code of conduct. In order to ensure enforcement, an ‘Ethics and Grievance Redressal Committee’, consisting of two sector experts and three ‘other independent persons’ was installed. Reports on compliance and complaints will be brought to the committee, which will then ask the institution to comment on the allegations. Sanctions then can include suspension and ultimately expulsion. To strengthen the punishment, expulsion will be brought to public notice.

Next to collecting financial data, Sa-Dhan started to collect social performance data of its members and analyse the implementation of the code of conduct. The first report on client protection and social performance was released in spring 2011 and presented at the yearly National Microfinance Conference, which Sa-Dhan organises.

b. MFIN

MFIN was established in 2009 as the Industry Association for NBFCs. It currently has 46 members. The rationale behind is to have an additional umbrella organization for those MFIs, which are regulated by the RBI.

‘All of us continue our membership and support of Sa-dhan. Sa-dhan is the wider body of all people doing microfinance, including not just microfinance providers but also people who are doing capacity building or research. It is like a congregation of everybody interested in microfinance. The NGOs, MFIs all are there, whereas MFIN is a very specific and focused subset that is only for NBFCs. Sa-dhan has 300 members, of which only 40 are NBFCs. So there is no conflict of interest. In fact, 2 of MFIN board members are also members of Sa-dhan’s board, and I have been involved with Sa-dhan. So as a founder of Sa-dhan I have no issues about Sa-dhan as such. MFIN was necessary. One reason for our creation of MFIN is that Sa-dhan is not an SRO. It is a conferencing and networking forum. Initially we asked Sa-dhan to create MFIN as an internal NBFC Division. We wanted some changes, but their general body didn’t vote in favour of it. But that’s fine, we continue our membership and continue to participate in Sa-dhan’s activities, but for specific RBI-related issues, we have our SRO.’ (Mahajan, MFIN was necessary for Indian Microfinance: Vijay Mahajan Interview, 2010)

MFIN aims to be a Self-regulatory-Organisation and also presented their code of conduct. The MFIN code is drafted more precise and definite, which makes it easier to enforce. For instance, it determines that a maximum of three MFIs can lend to one client, with a maximum loan size of Rs. 50,000, - by all three (Para. B.i. MFINCOC). It also provides for sharing of

data, for a whistle blowing mechanism and for an ombudsman. The MFIN COC⁴¹ includes an enforcement mechanism where the matter is brought to the Conduct Enforcement Committee, which then gives notice to other members, investors and the RBI (Para. F.iv. MFINCOC). Recently it set up a helpline for customers of any of their member MFIs (MFIN, 2011).

Sa-Dhan's and MFIN's nature as industry associations implies that they represent their members. To also sanction them is a difficult challenge.

'It's a very difficult situation for Sa-Dhan too; they also have to represent their members. So their pressure is limited. It has to be that way, there is no other way than saying: if you want to be my member in the industry association, you have to follow my criteria, otherwise you are not part of us.' (Alok, p.c.)

'The point is, how influential they are, because my interaction with Sa-Dhan says that they have good network, but the question is, how much these partner institutions listen to them, because the single objective of being partner with these kind of PMOs is getting funding easily, I mean that's the practicality' (Practitioner 1, p.c.)

Industry associations argue that they need lenders to strengthen their cause, claiming that 'until banks show active interest in assuring compliance through better lending terms, the associations will not be able to operate proactively' (Access, 2011, p. 12).

'For self-regulation there has to be some request to compliance by lenders and investors, if there is no requirement for this by them, it is not going to work. I guess that is why people are members of Sa-Dhan or MFIN anyways, to show their membership to lenders. So, if Sa-Dhan says, unless you comply with this code of conduct you will not be a member and if that leads to not being given any loans, then they have to comply.' (Alok, p.c.)

'The role that industry associations play, and the role that is accorded to industry associations by lenders, raters, RBI, bodies like that, if let's say, I'm an MFI which has only one single goal in mind, to make profit, it should be very hard for me to operate, without, let's say, the seal of approval of the industry body, whoever that is. But for me to go and get a loan from a bank, for instance, there have to be some preconditions, and so it should become difficult, it's only when that happens, everybody has to work in concession, it cannot be that MFIN has its set of standards and then there are people who are not members. [...]

When is such an association successful? When it gives you key benefits, which you will not get by being outside, so there comes a trade-off. If I want to continue receiving these benefits I have to comply. So the sanctions which are imposed are worth something.' (Practitioner 3, p.c.)

Alternatively, associations ask for the regulator to confer some powers to associations or to assign another official role to them, arguing that if 'associations are given a mandate by the regulator, then maybe there is a chance of legitimizing the process' (Access, 2011, p. 12). One

⁴¹ See Appendix

option would be to make membership a requirement for carrying out a microfinance business, as it is done with other professions.

‘Here, the associations are busy pleasing their members. [...] You have chartered accountant associations, banking associations, some of them work, but they are recognized by law. Existing associations don’t have recognition because there is no law itself. The fact is that India has no microfinance law, and it will not have one it looks like. RBI is saying why do you need a law if you only want RBI regulated agencies to be involved in Microfinance.’ (C.S. Reddy, p.c.)

By September 2011, none of the institutions had used their powers of expulsion and public shaming, which adds to the scepticism. On one side, industry associations claim that they need other stakeholders to put them in the position to pressure their members to comply. On the other side, the other stakeholders do not see why they should confer power to associations who seem to struggle to enforce action against their members.

‘First of all there has to be a proper formulation of the code of conduct, of consumer protection, and then the compliance has to be demanded by somebody. So either then the associations, MFIN and Sa-Dhan, have to demand it, or the investors, the shareholders from the market. All the lenders who finance, they have to demand it. It would need a combination of those. If they demand it, then they have to find ways to assess if those codes of conduct have been implemented properly. So there has to be an entire mechanism to enforce that code of conduct. And there has to be a penalty for violation of the code of conduct. If someone does not comply, there has to be a penalty. So, unless there are checks and balances, it will not work. Just having a code of conduct will not work.’ (Alok, p.c.)

‘It’s again a credibility issue. If I say: ‘I’m following all the rules’, people will trust you. First you have to become trustworthy. Both in the eyes of the public and in your own consumers’ eyes. Once you do that, self-regulation makes sense.’ (Ramana, p.c.)

The near future will show how industry associations solve this vicious cycle. I expect that they will take action against their members, in order to attain credibility. This would increase the value of membership. Currently, as one of my interview partners argued, the value of membership in industry associations should not be overrated, as ,almost every NBFC MFI is with MFIN, and almost every MFI worth a name is in Sa-Dhan, so that’s not a criteria’ (Practitioner 2, p.c.).

At the same time, the new regulatory framework strengthens the role of industry associations and will add weight to the sanction of expulsion from the industry association.

To include industry bodies in the regulatory regime is certainly adequate. Besides their capacity in monitoring, there also is a role for self-regulation ‘in getting institutions to begin a reporting process, or in articulating basic standards of good practice’ (Rosenberg, 2003, p.

104). Industry associations can act as a forum to discuss client protection and get institutions to open up to the idea and get convinced to engage in consumer protection – without being forced by a regulator, as ‘you cannot put in willingness [to follow self-regulation, author’s note] from the outside, that has to come from the inside’ (Practitioner 2, p.c.).

Another role that associations can play is to help client empowerment through financial literacy trainings and the like. In general, they are closer to both clients and the industry, which helps them to monitor regulation more closely and to react more flexible than a formal regulator.

‘Self-regulation is always good to have, but it’s not a must have. In a free market economy, self-regulation is difficult to enforce its code of conduct and penalize members and things like that, because it’s an association. It’s difficult, but it’s obviously not impossible and it’s always good to have, but once you already have a regulation, a lot of these things get sorted out. However, a self-regulatory body is always good to share best practices and other things like anti-poaching agreements to poach each other’s employees, that’s always good to have.’ (Arya, p.c.)

As another microfinance practitioner I interviewed pointed out, the real risk is that regulation – be it formal regulation or self-regulation – is not implemented.

‘A risk is that it will not be implemented. That is a risk: that it will not be implemented, as lenders will not insist on it. People will not accept it, because nobody implements it. There is no regulation, no control, no external assessment – in that situation it will not get enforced. [...] The regulator already has its own code of conduct; the investor association also has one. But somebody has to demand compliance on this. And there has to be a penalty for non-compliance.’ (Alok, p.c.)

Industry bodies adopted self-regulation measures in anticipation of regulation, as they experienced the effects of improper field practices. While they struggle with self-regulation, the state needs to assist associations and those MFIs by adopting a regulatory framework that also covers and sanctions institutions that do not even participate in discussions on consumer protection. To include industry bodies in the framework will help to ensure that regulation is also implemented and monitored.

4.4. The Level of Individual Institutions

‘Self-regulation has to work; obviously it comes from the mission of the organisation. Why are you working? So, make sure your purpose is getting achieved! Now if that purpose is only profit, then I’m sorry, but if you have a social mission, then obviously you have to make sure that all your actions, operations, policies, how people behave, everything is in alignment.’ (Practitioner 3, p.c.)

The missions of some of the biggest Indian MFIs read: ‘Our purpose is to eradicate poverty’ (SKS, 2011), ‘to be one of the most significant microfinance service provider by offering a range of financial and non-financial products and services to low income households and individuals to improve the quality of life’ (Spandana, 2011), ‘to reduce economic and social poverty significantly’ (Bandhan, 2011) or ‘to provide financial and support services to the poor, particularly women, for viable productive income-generating enterprises enabling them to reduce their poverty’ (SHARE, 2011). Considering these missions are supposed to be what is driving MFIs, the recent microfinance crisis and the apparent lack of awareness of clients’ needs seems very surprising.

‘MFIs need to become increasingly aware of the sensitivity of the type of clients being served and the need to synchronize/match their service to the needs and other development factor playing on the day to day lives of the poor. The importance of governance and the critical nature of the staff incentive system in the overall service delivery and social performance are other aspects the MFIs need to internalize.’ (Sa-Dhan, 2011c, p. 50)

The commercialization of microfinance is often claimed to have led to a mission drift, and that microfinance institutions need to be reminded of their mission is a strong indicator that a mission drift has indeed happened (see Iskenderian, 2011). One argument addressing this lack is that these missions and codes of conduct cannot be followed due to pressure from investors and regulators, as was already discussed in chapter 4.2.3.

‘When somebody is a private equity investor they cannot be a social investor, as a private equity investor looks for profit. For MFIs, which prefer the IPO route, the shareholders’ motive will be to maximise their return. At what cost a MFI maximises its profit is a moot point and profiteering in the name of commercialisation of microfinance is not desirable.’ (Practitioner 1, p.c.)

While funders certainly influence management decisions, MFIs themselves still have freedom of action and a corresponding responsibility.

‘Operations don’t change because of private equity investors. I don’t buy that. A board is there to give you a broad direction. The execution, how you want to do it, what you will do on the ground, is totally a management responsibility. The moment you mix up these two, you’re lost.’ (Practitioner 3, p.c.)

Regardless of the pressure of investors, ‘organizations have the best visibility on their functioning’ and investors ‘have to go by what the MFI says’, as was pointed out in a discussion on governance in MFIs last November (Access, 2011, p. 23).

An argument often heard was that the problem was not to be found at the management level but at the level of the field staff. Field staff was allegedly engaging in coercive practices and

over-lending because of the incentives that were used on the ground level without the managements' knowledge.

'The staff is provided incentives apart from a basic salary. The incentives are linked to productivity, efficiency and quality parameters. There is no incentive linkage to ticket size and repayment rates, to ensure avoidance of inappropriate lending and unethical recovery practices.' (Srinivasan N. , SSR, 2009, p. 52)

'The practices like incentives to the staff at the lower level for driving the business without adhering to accepted principles of lending and recovery is not appropriate and not in the interest of the microfinance sector. The top management of MFIs needs to take a strong note of this, as multiple lending to those whose incomes are very low and unethical recovery practices are outcomes of such practices.' (Practitioner 1, p.c.)

As I already noted above, I find it hard to believe that managements did not know of the heavy competition, practices of over-lending and aggressive recovery practices on the ground.

'Nobody, no MFI can come and say I have lent in area X and I have not known what was there already.' (Practitioner 2, p.c.)

Incentives and practices of field staff have been addressed by some organisations. From the tools, which the Smart Campaign is collecting from their endorsers and sharing publicly, a considerable share deals with staff training and codes for loan officers. All three 'call for tools winners' were addressing the institutional level (Smart Campaign, 2011). Two of these were designed by Indian MFIs. One was a tool to test the knowledge of the institution's code by staff; the other one was a tool for training loan officers on customer rights and responsibilities (ibid).

Still, practices of the field staff are one aspect of the management responsibility and cannot be analysed separately. Designing incentives and also scrutiny of field is a question of management. Just as the management chooses investors, they are the ones choosing field staff and putting in place incentives to achieve their mission. Already the decision to enter areas with a lot of competition is a step towards pushing staff to over-lend. The responsibility for an eventual mission drift is one of the whole institution and institutional practices. As Peg Ross from the Grameen Foundation's Human Capital Center put it:

'The organization must be very clear about frontline staff roles and their primary responsibilities. For example, providing effective financial services and helping to protect client interests are not mutually exclusive objectives, but the organization's recruitment and selection, learning and development, and rewards practices must all be aligned to help staff meet them. There must also be quantitative and qualitative performance objectives that clearly define the behaviours expected, such as honesty, respect, transparency, etc.

Now is a good time to rethink the use of incentives altogether. Some MFIs have either never

used incentives or have eliminated them with no negative consequences. And more and more private sector companies are realizing that employee motivation and commitment depend on many dimensions; money often plays just a small part.

[...] People tend to work toward what is expected — whether these expectations are high or low. In addition, keeping decisions at the top means that they are made far away from the people who have the most current information on clients and local conditions. Providing targeted learning and development opportunities to frontline staff that focus on what is needed to drive both financial and social results will increase capability and ensure that decisions can be made at the levels closest to where the challenges lie.

Organizational culture that stresses financial over social return. Creating and maintaining a culture that focuses on social as well as financial returns and embraces client protection principles requires intention and appropriate decisions/actions. Large, rapidly growing organizations may be tempted to cut corners on the selection and orientation and training of new hires, with the result that the organization's social mission, core values and long-term vision are not effectively communicated to the new hire. [...] In fact, adherence to these core values should be part of each employee's individual performance expectations.' (Ross, CGAP MF Blog, 2010c, marked as in original)

MFIs increasingly measure social performance. BASIX, for instance, works on building a 'system that incentivizes the growth of the customer over time' to strengthen compliance with the institutional mission (Access, 2011, p. 9).

Several institutions put a focus on responsible finance not only by endorsing campaigns and the code of conduct of associations but have also put in place their own codes of conduct. These codes are usually quite similar to the codes of industry associations. At a thematic retreat on client protection in Indian Microfinance the coexistence of various codes was discussed, which was seen as confusing (ibid, p.9). Sa-Dhan and MFIN have started a process of harmonising their codes of conduct.

Working with codes of conduct is one of the widest used forms of ensuring client protection for Indian MFIs. Next to adopting codes, these are also translated into regional languages and explained to staff in special trainings. Another often-used mechanism is to set up a complaint service reachable by telephone (ibid, p.10). Another option is to include client protection into regular internal audits, as some institutions do. The mere use of codes of conduct entails a high risk of being nothing more than window dressing, if they are not combined with a change of field practices⁴² and incentives. There are different intensities of fulfilling the quest for responsible finance:

'We started with a suggestion box at our branches, and when we reviewed that we felt that it

⁴² Besides changing incentives, the use of women as field staff seems to have a positive effect on recovery practices. See The Economic Times. (8th. December 2011). *Microfinance industry going all out to regain lost glory with women power.*

was one of those things that you can tick off on a survey, saying, yes, we have a customer complaint mechanism, but it's not something that is proactive that you know the customer is even comfortable using. So, we did a whole campaign and we put in two more measures, one is, we do an exit form for a sample of renewal loans and clients leaving. So, for these loans, there is a more detailed questionnaire with the client, to understand what they like, what they didn't. The other thing is, now we also have a customer helpline, and that we found is actually the most effective. We printed posters and publicised the number. We had flyers, we put it up at a lot of the branches, and we do get on average 8 to 10 calls a week on that line. And there is a dedicated resource at our back-office, answering those calls.' (Mehta Mankar, p.c.)

MFI practitioners feel that regulation only reaches the institutions who are engaging in client protection anyways or those, which the general public is aware of, while the 'true villains' are acting on the ground without being noticed.

'You have this whole set of operators who call themselves finance companies, who are registered, but also those who are not, who also operate in the villages and all. There's nothing being done about them, because they are nameless, faceless institutions.' (Practitioner 3, p.c.)

In order to avoid over-borrowing, credit bureaus were created (Hindustan Times, 2011). These bureaus collect financial data of microfinance clients. MFIs, who are assessing a loan, can check the loan history of a prospective client (See Sane et. al., 2011, 25f). Credit bureaus will only help, if the organisational culture behind changes. The microfinance market in Bosnia-Herzegovina, for instance, faced trouble after tremendous growth and competition. There, a credit bureau was functional. The competitive surrounding, however, led to weaker loan appraisals (Srinivasan, SSR 2010, p. 76f).

'The question is not whether there is multiple lending. The question is whether the lender knows the absorption and repayment capacity of the borrower. It is impossible to know this if we are doing a group meeting in 20 minutes and moving on. It is impossible to address this when we have standardised products and offer a higher loan each cycle. Our credit officers are trained to be robots following a process mechanically and are prohibited to think. Therefore multiple lending is a problem of the MFIs. We clearly do not know our customers enough, and do not have the time to know them.

There have been moves to have a credit bureau to address this problem. Is this not a joke? What will a centralised database covering Ganjam and Ernakulam, Chennai and Ludhiana tell me better than what my credit officer can tell? Every organisation operating in the area knows the other. We have asked our credit officers to chase targets. If only we ask our credit officers to treat this money as their own and see if it is worth lending to the client; if only we allow our credit officers to think.' (Sriram, WritersK Blog, 2010a)

While other stakeholders do have a responsibility too, and while pressure on MFIs was high, and while it is a very difficult task to monitor field practices, it is ultimately a management decision and responsibility how practices on the ground are. Certainly, a regulatory framework needs to address unregistered institutions, perhaps by encouraging MFIs to bring such actors to the notice of the RBI or State Governments. How MFIs practice microfinance,

however, is their matter and responsibility. As in most MFIs, the management is not able or willing to fulfil their organisational mission, an external regulator is needed.

‘I think it is something that is time and cost intensive for an MFI to set in place, so there needs to be enough management direction to say, yes it’s a priority for us, let’s put in the resources to do this. I don’t know how many people would make that call. I think if it is monitored by an external agency, it helps to ensure it is happening.’ (Mehta Mankar, p.c.)

In the same tune, MFIs cannot blame other involved stakeholders, be it investors or employees, for their own actions.

‘At the end of the day, it’s about doing what you really believe in, and if you really believe in it, you will find a way of doing it. [...] You should be governed by what you want to do, if that’s why you don’t want to do it, you’re weak at heart. Be firm with what you want to do, and if that necessitates stronger regulation, curbs, or that you have to get yourself audited every month, so be it’. (Practitioner 3, p.c.)

The crisis in Indian microfinance has often been described using the term ‘mission drift’, meaning that institutional growth can lead to a drift from the institutional mission to alleviate poverty. As I showed, most big MFIs include the goal to end or reduce poverty in their mission statement. In the institutional pursuit of growth, the focus to meet financial benchmarks was certainly stronger than the focus on poverty reduction. While I strongly believe that institutions have the most insight in field practices and that it is in their hands to provide responsible microfinance, it is obvious that not all MFIs are interested in doing so. Efforts of self-regulation and of individual MFIs are certainly important. However, they cannot replace a regulatory framework. Consumer protection in microfinance cannot depend on an institutional mission; it has to be the legal basis of operations.

4.5. The Level of the Borrower

As I stressed in my introduction, microfinance circles around the challenge to overcome lack of information. When discussing consumer protection in microfinance this lack of knowledge is also central. There is, on the one side, a lack of knowledge of behaviour and the actual needs of rural clients. On the other side, there is a lack of knowledge about financial products and terms of contract by customers.

Additionally, there is a lack of organisation on the clients' side, which would be needed to lobby for their rights. Consumer organisations rather focus on middle class clients than the poor. I think that this lack of representation is one of the reasons for frequent outbursts of collective disapproval by default or by harassing field staff, as formal complaint mechanisms are not existent or not widely known.

The imbalance of the bargaining process would require that clients know about their rights and understand the terms and consequences of the contracts they are signing. This information would strengthen their position in the bargaining process and enable competition of the many providers. Mere regulation of transparency lacks any effect when a borrower is illiterate. Disclosure of interest rates is useless when a client does not understand the way it is being calculated. A recent study pointed out that often, consumers actually do not perceive certain practices like seizure of assets as coercive, as they lack awareness of their rights (IFMR Centre for Microfinance, 2008, p. 16).

Consumer protection laws can improve these power imbalances by giving additional rights to clients. One is regulating cool-off-phases for clients, where they can step back from the contract (Porteous, 2009, p.7). This is a mechanism used in consumer protection for door-to-door selling in Europe. Again, such a provision is useless if it is not known or not used due to high costs of accessing the justice system.

To overcome the lack of consumer awareness and literacy a regulator can use a mechanism that precludes unwanted practices. N.V. Ramana, one of my interview partners, suggested to prescribe a specific day for centre meetings in every village as an easily manageable solution to avoid over-lending:

‘Suppose today the meeting of MFI x is over, Friday, yesterday was MFI y, day before yesterday was some other company, so each of them will have a meeting and each one of them will have 100% attendance and each member will have a loan which is getting repaid to whichever it is. [...] So one way if you really ask me how do you prevent certain things in consumer protection is: just fix a day. People will ask, how will you monitor? Malegam Committee very good, no multiple lending, but how will you monitor, one simple answer: people should have fixed days for meetings, all loan meetings should happen on Monday, period. Then the women can only attend one meeting. Money will come, but then there is a dilution of the company system, I'm saying if you really look at the political construct, if for a village there is one financial meeting fixed for a day, multiple lending will phenomenally reduce.’ (Ramana, p.c.)

To tackle the problem of financial illiteracy at its root, several stakeholders introduced financial literacy measures to enhance it. Better understanding of financial services and

products by clients should enable the consumer to make a prudent choice. Financial literacy is defined as ‘the ability to process financial information and make informed decisions about personal finances’ (IFMR Centre for Microfinance, 2008, p. 5). While better off clients usually know how to read and write, a lack of financial literacy is just as well being encountered and discussed in Europe⁴³ and the US^{44 45}.

Considering that the main cause for client distress was over-lending without a proper assessment of clients’ repayment capacity, increasing financial literacy can shape consumers’ behaviour so they understand the risks of over-borrowing. The capacity to deal with the oversupply of credit is critical, as it tackles the problem of over-lending at the root.

‘At the household level, there should be a push to build greater financial literacy, so that customers know the consequences of over borrowing and the benefits of savings and insurance in adversity.’ (Mahajan in Microfinance Insights, 2009)

‘People have this argument, there’s too much of supply, so people are greedy and take. I don’t believe in that ‘people are greedy’ thing at all. It’s more – you’re also in this surrounding world in which your aspirations are being pumped up, you look at urban spaces and even in villages, TV is such a household thing, and what you have on TV, all these soap operas and stuff like that which comes, you have a very high standard of living which is projected over there. So people have dreams, which I don’t say is bad, but how do you manage those aspirations, how do you plan for those aspirations, that’s where I think there’s a huge gap today in terms of financial planning, financial literacy, understanding all these terms, and therefore, for instance, if I have a family for two children, one is their education, one is their marriage, making sure for day to day expenses and long term needs, so how do you make sure for all of that. Now you have this kind of planning, and then you have a multitude of institutions knocking on your door, offering a loan. Taking a loan has become very easy, there are lots of institutions going to an area, and then they just start disbursing loans, without knowing the people, without doing a survey.’ (Practitioner 3, p.c.)

⁴³ For OECD Countries see: Smith, B. E., & Stewart, F. (2008). Learning from the Experience of Organisation for Economic Co-operation and Development Countries: Lessons for Policy, Programs, and Evaluations. In A. Lusardi, *Overcoming the Saving Slump: How to increase the effectiveness of financial education and saving programs* (S. 345-368). Chicago, US: University of Chicago Press

For the EU see: TNS Opinion & Social on request of Eurostat and the Directorate-General for Health and Consumers (DG SANCO). (2011). *Eurobarometer no 342: Consumer Empowerment*. Eurobarometer, Brussels.

⁴⁴ For the US see: U.S. Department of the Treasury. (2011). *Resource Center*. Retrieved 24th September 2011 from <http://www.treasury.gov/resource-center/financial-education/Pages/default.aspx> or Braunstein, S., & Welch, C. (2002). Financial Literacy: An Overview of Practical Research, and Policy. *Federal Reserve Bulletin* (88), 445-458.

⁴⁵ In general, Indians have better financial literacy levels than consumers from e.g. the US, the Netherlands or Korea, as a recent study found out Indian Express. (2011, January 15th). *Indians more fin literate than most: Survey*. Retrieved September 24th, 2011 from <http://www.indianexpress.com/news/indians-more-fin-literate-than-most-survey/737587/0>.

There are some recent studies on financial capabilities of clients to find out how well borrowers understand their loan. Also, there are various efforts to increase financial literacy of clients by MFIs, associations and the Indian government.

‘ “There should not be a double negative. This means even if I don't want a product, I'm saddled with it. For instance, I need to tell I don't need an insurance policy or I automatically get an insurance policy,” said Deepali Pant Joshi, chief general manager, Reserve Bank of India (RBI). “This is what we are uncomfortable with. Because we are dealing with vulnerable and poor clientele, we don't want products to be pushed through to them,” she said, while addressing a seminar on financial inclusion in Mumbai on Tuesday. [...] Over the last two years, banks have embarked on the financial inclusion drive to cover under-banked and un-banked villages in India. No-frills, or zero balance, accounts are opened at doorsteps on the submission of basic know-your-customer norms. [...] She also said banks needed to insure financial literacy while meeting their inclusion targets. “They (customers) must understand the products they are getting, and from the demand side, financial literacy becomes all the more important,” she said.’ (Business Standard, 2011b)

Also Sa-Dhan stresses the importance of financial literacy as a pre-condition for an effective consumer protection:

‘In India, the Sa-Dhan Code of Conduct, referred to earlier in this paper, exhorts its members to disclose their interest rates and funding costs to clients by posting them inside their offices. [...] While these efforts are laudable, it is also important to appreciate that unless MFI clients in these countries understand interest rates and can calculate them, these regulations are meaningless and will have no impact.’ (IFMR Centre for Microfinance, 2008, p. 6)

The MFI Ujjivan started a Financial Literacy Training called Diksha. They released a 30-minute long video⁴⁶, which is intended to raise awareness. It is screened at centre meetings, but also in local cable TV (Ujjivan, 2011) to also reach those who are not Ujjivan clients. It focuses on over-lending. Additionally, a voluntary follow up training programme will be conducted, which includes training of numerical skills, budgeting and planning for expenses.

The modalities to conduct financial literacy can become quite complex too. Swadhaar, another MFI that conducts financial literacy trainings, realized that these should not be made mandatory.

‘What we do is that most areas where we have our microcredit operations are covered by SFA with its Financial Education program. They work with clients and non-clients, and are not restricted only to Swadhaar clients. Anybody who takes a loan from Swadhaar in those areas is offered these services if they would like to go. We found earlier that making this a mandatory part of the loan process meant that then the clients interaction or involvement in the process was very different. If they come and attend the session only because they think they will otherwise not, their level of interest is very different from when they actually choose to attend

⁴⁶ A 10 min long trailer can be watched at <http://www.youtube.com/watch?v=VIKfIRIcSaY> , retrieved August 25th, 2011.

themselves. We've had a lot of cases where a small initial group attends and very good word of mouth feedback is generated. The course is designed to be a lot of fun, with the contents being delivered through games, pictures and exercises. We have even had clients come and ask our loan officers, "you know, I have a friend who attended that, where can I go to attend it?" We are now looking at covering our entire area of operations with this.' (Mehta Mankar, p.c.)

Often, institutions conduct financial literacy trainings when they offer financial products, as the time clients apply for a loan is when they show the strongest interest:

'Many financial literacy programs rely on providing information or increasing knowledge, but this does not necessarily result in a change in behavior. Research suggests the links to desired practice are strongest when linked to "a teachable moment"—for example, providing home loan education when a consumer is first searching for a house; or retirement financing when entering the workforce. Most people continue to learn from family and friends; but if there were to be a scale rollout, using popular media such as TV or radio would be important.' (Porteous, 2009, p.12, with reference to Hilgert and Hogarth, 2003,⁴⁷).

Still, like in other contexts, humans sometimes take bad decisions despite knowing better.

'Experiments in behavioral economics have demonstrated that human attitudes and actions have systematic patterns which deviate from the rational; and that these deviations have important effects on credit markets. Even when human beings are well informed about their choices, they are inherently subject to behavioral biases.' (Porteous, 2009, p.9)

The irrationality of human behaviour is the boundary for financial literacy measures as well as for consumer protection.

Besides consumers understanding financial products and knowing about their rights, installing a complaint mechanism is important to ensure compliance and monitor ground practices.

'Wherever you have structured, widespread consumer activity, and there's a likelihood of an exploiter, the regulator has a role to play, but only so much. The grievance mechanism is what really is going to help out.' (Rajagopalan, p.c.)

While industry associations and many MFIs have installed telephone help-lines and ombudsman mechanisms, an independent helpline is still lacking. GIZ is trying to fill this gap in India, by including the microfinance sector into their project 'Sustainable Consumption and Consumer Protection'⁴⁸. The goal is to include microfinance clients in the Indian consumer

⁴⁷ Hilgert, M & J.M.Hogarth (2003) "Household Financial Management; The Connection between Knowledge and Behavior" Federal Reserve Bulletin 89.7:301-322.

⁴⁸ <http://www.asefindia.com/Projects.aspx?Title=Sustainable+Consumption+and+Consumer+Protection&Sectionid=2&subsectionid=10&rowid=13> , retrieved August 23rd, 2011.

advisory network⁴⁹, which is supported by GIZ. This would be the first project providing independent advice to microfinance clients, both before and after clients take a credit.

Training financial literacy is a major need in order to ensure that clients make informed decisions and to strengthen their negotiating power. Again, this is not a developmental agenda, but part of providing financial services in a fair manner. Financial literacy is a matter equally discussed in the west and aiming at balancing diverging levels of information. It should be distinguished from so-called ‘microfinance plus’ services that some MFIs offer, often through NGOs. As the realisation that microfinance alone has limited impact on development parameters is gaining ground, these services provide livelihood assistance like business and agricultural trainings.

‘You need to bundle the microfinance service with certain additional services in order for it to even be viable. That needs to be livelihood development, or a higher component of financial literacy, more handholding along the loan-path. And these are all aspects which is not easy for an MFI to do it on a cost-to-cost basis, because the clients won’t be able to pay.’ (Mehta Mankar. p.c.)

While I argue for a regulatory system for the Indian microfinance market, which should be driven by the Indian government, including industry associations, there should at the same time be efforts to include microfinance clients in this regime. First of all, by giving them a system of legal redress that they can access and use. Additionally, to include clients in the process, an organisation presenting the needs of clients is needed. Another issue is the lack of financial literacy: every instrument used has to take account of the actual knowledge and capabilities of microfinance clients.

However, these issues are all occurring in other financial markets too and are not unique to microfinance. To address microfinance as a financial service, and not a development programme, also helps consumers: from their perspective, it is irrelevant who is providing financial services to them; they should all have to follow the same regulatory standards.

⁴⁹ For further information see <http://www.consumeradvice.in> , retrieved August 23rd, 2011.

5. CONCLUSION

In microfinance, there is an informational asymmetry to the disadvantage of consumers, which has been largely ignored so far.

As competition and commercialization increased in the Indian microfinance market, this asymmetry has led to a severe crisis. Competition did not lead to improved products and a stronger negotiating position of consumers, but instead to excessive borrowing and indebted clients. Large numbers of clients stopped repaying their loans, threatening the stability of several micro-finance institutions.

The joint liability group (JLG) model, which is widely used at the moment, has severe shortcomings and requires reconsideration. At the moment, however, there are almost no efforts in this direction.

Additionally, it is important to reconsider the classification of microfinance as a means of development assistance. It is a financial service for poor people - useful and needed - which we should not expect to end poverty. Just like with any other financial service, there is a need for consumer protection to balance current informational asymmetries.

Clients in all low-income markets, including the microfinance market, would need even stronger protection than middle class consumers. Instead, they do not even enjoy a protection equal to them. An institution representing interests of the poor is missing.

A coherent regulatory regime would be needed to improve this balance. In India there are various efforts of regulation, a unified law on microfinance is still lacking. Due to a constitutional conflict on the competence to regulate microfinance, it is still unregulated.

I portrayed the efforts of the regulator, funders, institutions and industry associations to meet this need for regulation and came to the conclusion that none of these efforts can substitute for a unified legal framework.

While the draft of the central microfinance bill appoints the RBI as the main regulator, the actual bill has not yet been passed. It would be needed in order to regulate the sector nationwide, so that banks and investors can readapt their strategies and eventually start lending to struggling MFIs again.

Membership in industry associations is voluntary. The hesitance of the Indian parliament is also impeding the self-regulatory efforts of industry associations, as those who refuse to be regulated do not have to justify themselves before any (other) body. While industry associations have the most knowledge of the actualities of microfinance practices, they struggle to sanction their members.

Individual institutions have experienced a mission drift. I argue that it was wrong to judge them by their mission statement in the first place. Instead, they should be judged by the services they actually provide, be it credit or any other service. While it is highly valuable if microfinance institutions aim to reach developmental goals and offer services accordingly, they simply cannot be treated differently as far as consumer protection is concerned.

Funders, on the other hand, are hard to govern under Indian law. Alternative ways of scrutiny are therefore crucial to ensure adequate consumer protection. Donors for instance, are increasingly facing scrutiny by their parliaments. Banks and investors have started engaging in self-regulatory efforts. Considering that the involvement of Indian banks has been advocated by the Indian state in order to achieve financial inclusion, similar mechanisms might also help to increase their efforts in consumer protection.

While addressing all these actors and their role in consumer protection, the actual consumers should not be left out.

Institutions are needed to represent poor consumers and ensure consumer rights.

There is need for a complaint and redress mechanism that they can access and use.

Additionally, the issue of the lack of financial literacy needs to be addressed: every instrument used has to take the actual knowledge and capabilities of microfinance clients into account.

All these measures are not unique to microfinance. To address microfinance as a financial service, and not a development programme, also helps consumers: from their perspective, it is irrelevant who is providing financial services to them, so all financial institutions should have to follow the same regulatory standards.

In order to balance the lack of information of clients in financial markets, consumer protection is needed. This equally holds true for microfinance services. Microfinance clients should be regarded as consumers, not entrepreneurs, and offered adequate protection. This lesson is being learnt in India but equally applies to other microfinance markets.

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APPENDIX – RELEVANT DOCUMENTS

THE CONSTITUTION OF INDIA (SELECTED PROVISIONS)

PART XI

RELATIONS BETWEEN THE UNION AND THE STATES

CHAPTER I.—LEGISLATIVE RELATIONS

Distribution of Legislative Powers

245. Extent of laws made by Parliament and by the Legislatures of States.—(1) Subject to the provisions of this Constitution, Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State.

(2) No law made by Parliament shall be deemed to be invalid on the ground that it would have extra-territorial operation.

246. Subject-matter of laws made by Parliament and by the Legislatures of States.—(1) Notwithstanding anything in clauses (2) and (3), Parliament has exclusive power to make laws with respect to any of the matters enumerated in List I in the Seventh Schedule (in this Constitution referred to as the “Union List”).

(2) Notwithstanding anything in clause (3), Parliament, and, subject to clause (1), the Legislature of any State also, have power to make laws with respect to any of the matters enumerated in List III in the Seventh Schedule (in this Constitution referred to as the “Concurrent List”).

(3) Subject to clauses (1) and (2), the Legislature of any State has exclusive power to make laws for such State or any part thereof with respect to any of the matters enumerated in List II in the Seventh Schedule (in this Constitution referred to as the “State List”).

(4) Parliament has power to make laws with respect to any matter for any part of the territory of India not included in a State notwithstanding that such matter is a matter enumerated in the State List.

247. Power of Parliament to provide for the establishment of certain additional courts.—Notwithstanding anything in this Chapter, Parliament may by law provide for the establishment of any additional courts for the better administration of laws made by Parliament or of any existing laws with respect to a matter enumerated in the Union List.

48. Residuary powers of legislation.—(1) Parliament has exclusive power to make any law with respect to any matter not enumerated in the Concurrent List or State List.

(2) Such power shall include the power of making any law imposing a tax not mentioned in either of those Lists.

249. Power of Parliament to legislate with respect to a matter in the State List in the national interest.—(1) Notwithstanding anything in the foregoing provisions of this Chapter, if the Council of States has declared by resolution supported by not less than two-thirds of the members present and voting that it is necessary or expedient in the national interest that Parliament should make laws with respect to any matter enumerated in the State List specified in the resolution, it shall be lawful for Parliament to make laws for the whole or any part of the territory of India with respect to that matter while the resolution remains in force.

(2) A resolution passed under clause (1) shall remain in force for such period not exceeding one year as may be specified therein:

Provided that, if and so often as a resolution approving the continuance in force of any such resolution is passed in the manner provided in clause (1), such resolution shall continue in force for a further period of one year from the date on which under this clause it would otherwise have ceased to be in force.

(3) A law made by Parliament which Parliament would not but for the passing of a resolution under clause (1) have been competent to make shall, to the extent of the incompetency, cease to have effect on the expiration of a period of six months after the resolution has ceased to be in force, except

as respects things done or omitted to be done before the expiration of the said period.

251. Inconsistency between laws made by Parliament under articles 249 and 250 and laws made by the Legislatures of States.—Nothing in articles 249 and 250 shall restrict the power of the Legislature of a State to make any law which under this Constitution it has power to make, but if any provision of a law made by the Legislature of a State is repugnant to any provision of a law made by Parliament which Parliament has under either of the said articles power to make, the law made by Parliament, whether passed before or after the law made by the Legislature of the State, shall prevail, and the law made by the Legislature of the State shall to the extent of the repugnancy, but so long only as the law made by Parliament continues to have effect, be inoperative.

252. Power of Parliament to legislate for two or more States by consent and adoption of such legislation by any other State.—(1) If it appears to the Legislatures of two or more States to be desirable that any of the matters with respect to which Parliament has no power to make laws for the States except as provided in articles 249 and 250 should be regulated in such States by Parliament by law, and if resolutions to that effect are passed by all the Houses of the Legislatures of those States, it shall be lawful for Parliament to pass an act for regulating that matter accordingly, and any Act so passed shall apply to such States and to any other State by which it is adopted afterwards by resolution passed in that behalf by the House or, where there are two Houses, by each of the Houses of the Legislature of that State.

(2) Any Act so passed by Parliament may be amended or repealed by an Act of Parliament passed or adopted in like manner but shall not, as respects any State to which it applies, be amended or repealed by an Act of the Legislature of that State.

254. Inconsistency between laws made by Parliament and laws made by the Legislatures of States.—(1) If any provision of a law made by the Legislature of a State is repugnant to any provision of a law made by Parliament which Parliament is competent to enact, or to any provision of an existing law with respect to one of the matters enumerated in the Concurrent List, then, subject to the provisions of clause (2), the law made by Parliament, whether passed before or after the law made by the Legislature of such State, or, as the case may be, the existing law, shall prevail and the law made by the Legislature of the State shall, to the extent of the repugnancy, be void.

(2) Where a law made by the Legislature of a State with respect to one of the matters enumerated in the Concurrent List contains any provision repugnant to the provisions of an earlier law made by Parliament or an existing law with respect to that matter, then, the law so made by the Legislature of such State shall, if it has been reserved for the consideration of the President and has received his assent, prevail in that State:

Provided that nothing in this clause shall prevent Parliament from enacting at any time any law with respect to the same matter including a law adding to, amending, varying or repealing the law so made by the Legislature of the State.

CHAPTER II.—ADMINISTRATIVE RELATIONS

General

256. Obligation of States and the Union.—The executive power of every State shall be so exercised as to ensure compliance with the laws made by Parliament and any existing laws which apply in that State, and the executive power of the Union shall extend to the giving of such directions to a State as may appear to the Government of India to be necessary for that purpose.

257. Control of the Union over States in certain cases.—(1) The executive power of every State shall be so exercised as not to impede or prejudice the exercise of the executive power of the Union, and the executive power of the Union shall extend to the giving of such directions to a State as may appear to the Government of India to be necessary for that purpose.

(2) The executive power of the Union shall also extend to the giving of directions to a State as to the construction and maintenance of means of communication declared in the direction to be of national or military importance:

Provided that nothing in this clause shall be taken as restricting the power of Parliament to declare highways or waterways to be national highways or national waterways or the power of the Union with respect to the highways or waterways so declared or the power of the Union to construct

and maintain means of communication as part of its functions with respect to naval, military and air force works.

(3) The executive power of the Union shall also extend to the giving of directions to a State as to the measures to be taken for the protection of the railways within the State.

(4) Where in carrying out any direction given to a State under clause (2) as to the construction or maintenance of any means of communication or under clause (3) as to the measures to be taken for the protection of any railway, costs have been incurred in excess of those which would have been incurred in the discharge of the normal duties of the State if such direction had not been given, there shall be paid by the Government of India to the State such sum as may be agreed, or, in default of agreement, as may be determined by an arbitrator appointed by the Chief Justice of India, in respect of the extra costs so incurred by the State.

258. Power of the Union to confer powers, etc., on States in certain cases.—(1) Notwithstanding anything in this Constitution, the President may, with the consent of the Government of a State, entrust either conditionally or unconditionally to that Government or to its officers functions in relation to any matter to which the executive power of the Union extends.

(2) A law made by Parliament which applies in any State may, notwithstanding that it relates to a matter with respect to which the Legislature of the State has no power to make laws, confer powers and impose duties, or authorise the conferring of powers and the imposition of duties, upon the State or officers and authorities thereof.

(3) Where by virtue of this article powers and duties have been conferred or imposed upon a State or officers or authorities thereof, there shall be paid by the Government of India to the State such sum as may be agreed, or, in default of agreement, as may be determined by an arbitrator appointed by the Chief Justice of India, in respect of any extra costs of administration incurred by the State in connection with the exercise of those powers and duties.

258A. Power of the States to entrust functions to the Union.—Notwithstanding anything in this Constitution, the Governor of a State may, with the consent of the Government of India, entrust either conditionally or unconditionally to that Government or to its officers functions in relation to any matter to which the executive power of the State extends.

261. Public acts, records and judicial proceedings.—(1) Full faith and credit shall be given throughout the territory of India to public acts, records and judicial proceedings of the Union and of every State.

(2) The manner in which and the conditions under which the acts, records and proceedings referred to in clause (1) shall be proved and the effect thereof determined shall be as provided by law made by Parliament.

(3) Final judgments or orders delivered or passed by civil courts in any part of the territory of India shall be capable of execution anywhere within that territory according to law.

Co-ordination between States

263. Provisions with respect to an inter-State Council.—If at any time it appears to the President that the public interests would be served by the establishment of a Council charged with the duty of—

(a) inquiring into and advising upon disputes which may have arisen between States;

(b) investigating and discussing subjects in which some or all of the States, or the Union and one or more of the States, have a common interest; or

(c) making recommendations upon any such subject and, in particular, recommendations for the better co-ordination of policy and action with respect to that subject,

it shall be lawful for the President by order to establish such a Council, and to define the nature of the duties to be performed by it and its organisation and procedure.

SEVENTH SCHEDULE

(Article 246)

List I—Union List

43. Incorporation, regulation and winding up of trading corporations, including banking, insurance and financial corporations, but not including co-operative societies.

44. Incorporation, regulation and winding up of corporations, whether trading or not, with objects not confined to one State, but not including universities.

45. Banking.

47. Insurance.

48. Stock exchanges and futures markets.

List II—State List

30. Money-lending and money-lenders; relief of agricultural indebtedness.

32. Incorporation, regulation and winding up of corporations, other than those specified in List I, and universities; unincorporated trading, literary, scientific, religious and other societies and associations; co-operative societies.

CONSUMER PROTECTION ACT (1986) (SELECTED PROVISIONS)

An Act to provide for better protection of the interests of consumers and for that purpose to make provision for the establishment of consumer councils and other authorities for the settlement of consumers' disputes and for matters connected therewith.

BE it enacted by Parliament in the Thirty-seventh Year of the Republic of India as follows:—

CHAPTER I

PRELIMINARY

1. Short title, extent, commencement and application.—

- (1) This Act may be called the Consumer Protection Act, 1986.
- (2) It extends to the whole of India except the State of Jammu and Kashmir.
- (3) It shall come into force on such date as the Central Government may, by notification, appoint and different dates may be appointed for different States and for different provisions of this Act.
- (4) Save as otherwise expressly provided by the Central Government by notification, this Act shall apply to all goods and services.

2. Definitions.—

- (1) In this Act, unless the context otherwise requires,—

(b) 'complainant' means—

- (i) a consumer; or
- (ii) any voluntary consumer association registered under the Companies Act, 1956 (1 of 1956) or under any other law for the time being in force; or
- (iii) the Central Government or any State Government,
- (iv) one or more consumers, where there are numerous consumers having the same interest;
- (v) in case of death of a consumer, his legal heir or representative;

who or which makes a complaint;

(c) 'complaint' means any allegation in writing made by a complainant that—

- (i) an unfair trade practice or a restrictive trade practice has been adopted by any trader or service provider ;
- (ii) the goods bought by him or agreed to be bought by him; suffer from one or more defects;
- (iii) the services hired or availed of or agreed to be hired or availed of by him suffer from deficiency in any respect;
- (iv) a trader or service provider, as the case may be, has charged for the goods or for the service mentioned in the complaint a price in excess of the price –
 - (a) fixed by or under any law for the time being in force
 - (b) displayed on the goods or any package containing such goods ;
 - (c) displayed on the price list exhibited by him by or under any law for the time being in force;
 - (d) agreed between the parties;
- (v) goods which will be hazardous to life and safety when used or being offered for sale to the public,--
 - (A) in contravention of any standards relating to safety of such goods as required to be complied with, by or under any law for the time being in force;
 - (B) if the trader could have known with due diligence that the goods so offered are unsafe to the public;
- (vi) services which are hazardous or likely to be hazardous to life and safety of the public when used, are being offered by the service provider which such person could have known with due diligence to be injurious to life and safety;”;

..(d) 'consumer' means any person who—

- (i) buys any goods for a consideration which has been paid or promised or partly paid and partly promised, or under any system of deferred payment and includes any user of such goods other than the person who buys such goods for consideration paid or promised or partly paid

or partly promised, or under any system of deferred payment when such use is made with the approval of such person, but does not include a person who obtains such goods for resale or for any commercial purpose; or

(ii) hires or avails of any services for a consideration which has been paid or promised or partly paid and partly promised, or under any system of deferred payment and includes any beneficiary of such services other than the person who 'hires or avails of the services for consideration paid or promised, or partly paid and partly promised, or under any system of deferred payment, when such services are availed of with the approval of the first mentioned person but does not include a person who avails of such services for any commercial purposes;

Explanation.—For the purposes of this clause, “commercial purpose” does not include use by a person of goods bought and used by him and services availed by him exclusively for the purposes of earning his livelihood by means of self-employment;

..(e) 'consumer dispute' means a dispute where the person against whom a complaint has been made, denies or disputes the allegations contained in the complaint.

..(f) 'defect' means any fault, imperfection or shortcoming in the quality, quantity, potency, purity or standard which is required to be maintained by or under any law for the time being in force under any contract, express or implied or as is claimed by the trader in any manner whatsoever in relation to any goods;

..(g) 'deficiency' means any fault, imperfection, shortcoming or inadequacy in the quality, nature and manner of performance which is required to be maintained by or under any law for the time being in force or has been undertaken to be performed by a person in pursuance of a contract or otherwise in relation to any service;

..(h) 'District Forum' means a Consumer Disputes Redressal Forum established under clause (a) of section 9;

(i.) 'goods' means goods as defined in the Sale of Goods Act, 1930;

(k) 'National Commission' means the National Consumer Disputes Redressal Commission established under clause (c) of section 9;

(l) 'notification' means a notification published in the Official Gazette;

(m) 'person' includes,—

(i) a firm whether registered or not;

(ii) a Hindu undivided family;

(iii) a co-operative society;

(iv) every other association of persons whether registered under the Societies R(21 of 1860) or not;

(n) 'prescribed' means prescribed by rules made by the State Government, or as the case may be, by the Central Government under this Act;

(nn) “regulation” means the regulations made by the National Commission under this Act;

(nnn) “restrictive trade practice” means a trade practice which tends to bring about manipulation of price or conditions of delivery or to affect flow of supplies in the market relating to goods or services in such a manner as to impose on the consumers unjustified costs or restrictions and shall include—

(a) delay beyond the period agreed to by a trader in supply of such goods or in providing the services which has led or is likely to lead to rise in the price;

(b) any trade practice which requires a consumer to buy, hire or avail of any goods or, as the case may be, services as condition precedent to buying, hiring or availing of other goods or services;

(o) 'service' means service of any description which is made available to potential users and includes, but not limited to, the provision of facilities in connection with banking, financing insurance, transport, processing, supply of electrical or other energy, board or lodging or both, housing construction, entertainment, amusement or the purveying of news or other information, but does not include the rendering of any service free of charge or under a contract of personal service;

(oo) “spurious goods and services” mean such goods and services which are claimed to be genuine but they are actually not so;

(p) 'State Commission' means a Consumer Disputes Redressal Commission established in a State under clause (b) of section 9;

(q) 'trader' in relation to any goods means a person who sells or distributes any goods for sale and includes the manufacturer thereof, and where such goods are sold or distributed in package form, includes the packer thereof;

(r) 'unfair trade practice' means a trade practice which, for the purpose of promoting the sale, use or supply of any goods or for the provision of any service, adopts any unfair method or unfair or deceptive practice including any of the following practices, namely;—

(1) the practice of making any statement, whether orally or in writing or by visible representation which,—

(i) falsely represents that the goods are of a particular standard, quality, quantity, grade, composition, style or model;

(ii) falsely represents that the services are of a particular standard, quality or grade;

(iii) falsely represents any re-built, second-hand, renovated, reconditioned or old goods as new goods;

(iv) represents that the goods or services have sponsorship, approval, performance, characteristics, accessories, uses or benefits which such goods or services do not have;

(v) represents that the seller or the supplier has a sponsorship or approval or affiliation which such seller or supplier does not have;

(vi) makes a false or misleading representation concerning the need for, or the usefulness of, any goods or services;

(vii) gives to the public any warranty or guarantee of the performance, efficacy or length of life of a product or of any goods that is not based on an adequate or proper test thereof;

Provided that where a defence is raised to the effect that such warranty or guarantee is based on adequate or proper test, the burden of proof of such defence shall lie on the person raising such defence;

(viii) makes to the public a representation in a form that purports to be—

(i) a warranty or guarantee of a product or of any goods or services; or

(ii) a promise to replace, maintain or repair an article or any part thereof or to repeat or continue a service until it has achieved a specified result, if such purported warranty or guarantee or promise is materially misleading or if there is no reasonable prospect that such warranty, guarantee or promise will be carried out;

(ix) materially misleads the public concerning the price at which a product or like products or goods or services, have been or are, ordinarily sold or provided, and, for this purpose, a representation as to price shall be deemed to refer to the price at which the product or goods or services has or have been sold by sellers or provided by suppliers generally in the relevant market unless it is clearly specified to be the price at which the product has been sold or services have been provided by the person by whom or on whose behalf the representation is made;

(x) gives false or misleading facts disparaging the goods, services or trade of another person.

Explanation.—For the purposes of clause (1), a statement that is—

(a) expressed on an article offered or displayed for sale, or on its wrapper or container; or

(b) expressed on anything attached to, inserted in, or accompanying, an article offered or displayed for sale, or on anything on which the article is mounted for display or sale; or

(c) contained in or on anything that is sold, sent, delivered, transmitted or in any other manner whatsoever made available to a member of the public,

shall be deemed to be a statement made to the public by, and only by, the person who had caused the statement to be so expressed, made or contained;

(4) permits the sale or supply of goods intended to be used, or are of a kind likely to be used, by consumers, knowing or having reason to believe that the goods do not comply with the standards prescribed by competent authority relating to performance, composition, contents, design, constructions, finishing or packaging as are necessary to prevent or reduce the risk of injury to the person using the goods;

(6) manufacture of spurious goods or offering such goods for sale or adopts deceptive practices in the provision of services.

(2) Any reference in this Act to any other Act or provision thereof which is not in force in any area to which this Act applies shall be construed to have a reference to the corresponding Act or provision thereof in force in such area.

3. Act not in derogation of any other law.—The provisions of this Act shall be in addition to and not in derogation of the provisions of any other law for the time being in force.

CHAPTER II

CONSUMER PROTECTION COUNCILS

4. The Central Consumer Protection Council.—(1) The Central Government shall, by notification, establish with effect from such date as it may specify in such notification, a Council to be known as the Central Consumer Protection Council (hereinafter referred to as the Central Council).

(2) The Central Council shall consist of the following members, namely:—

- (a) the Minister in charge of the consumer affairs in the Central Government, who shall be its Chairman, and
- (b) such number of other official or non-official members representing such interests as may be prescribed.

5. Procedure for meetings of the Central Council.—(1) The Central Council shall meet as and when necessary, but at least one meeting of the Council shall be held every year.

(2) The Central Council shall meet at such time and place as the Chairman may think fit and shall observe such procedure in regard to the transaction of its business as may be prescribed.

6. Objects of the Central Council.—The objects of the Central Council shall be to promote and protect the rights of the consumers such as,—

- (a) the right to be protected against the marketing of goods and services which are hazardous to life and property;
- (b) the right to be informed about the quality, quantity, potency, purity, standard and price of goods or services, as the case may be so as to protect the consumer against unfair trade practices;
- (c) the right to be assured, wherever possible, access to a variety of goods and services at competitive prices;
- (d) the right to be heard and to be assured that consumer's interests will receive due consideration at appropriate forums;
- (e) the right to seek redressal against unfair trade practices or restrictive trade practices or unscrupulous exploitation of consumers; and
- (f) the right to consumer education.

7. The State Consumer Protection Councils.—(1) The State Government shall, by notification, establish with effect from such date as it may specify in such notification, a Council to be known as the Consumer Protection Council for..... (hereinafter referred to as the State Council).

(2) The State Council shall consist of the following members, namely:—

- (a) the Minister incharge of consumer affairs in the State Government who shall be its Chairman;
 - (b) such number of other official or non-official members representing such interests as may be prescribed by the State Government.
 - (c) such number of other official or non-official members, not exceeding ten, as may be nominated by the Central Government.
- (3) The State Council shall meet as and when necessary but not less than two meetings shall be held every year.
- (4) The State Council shall meet at such time and place as the Chairman may think fit and shall observe such procedure in regard to the transaction of its business as may be prescribed by the State Government.

8. Objects of the State Council.—The objects of every State Council shall be to promote and protect within the State the rights of the consumers laid down in clauses (a) to (f) of section 6.

8A. (1) The State Government shall establish for every district, by notification, a council to be known as the District Consumer Protection Council with effect from such date as it may specify in such notification.

(2) The District Consumer Protection Council (hereinafter referred to as the District Council) shall consist of the following members, namely:—

- (a) the Collector of the district (by whatever name called), who shall be its Chairman; and
- (b) such number of other official and non-official members representing such interests as may be prescribed by the State Government.

(3) The District Council shall meet as and when necessary but not less than two meetings shall be held every year.

(4) The District Council shall meet at such time and place within the district as the Chairman may think fit and shall observe such procedure in regard to the transaction of its business as may be prescribed by the State Government.

8B. The objects of every District Council shall be to promote and protect within the district the rights of the consumers laid down in clauses (a) to (f) of section 6.

CHAPTER III

CONSUMER DISPUTES REDRESSAL AGENCIES

9. Establishment of Consumer Disputes Redressal Agencies. There shall be established for the purposes of this Act, the following agencies, namely:—

- (a) a Consumer Disputes Redressal Forum to be known as the 'District Forum' established by the State Government in each district of the State by notification:

Provided that the State Government may, if it deems fit, establish more than one District Forum in a district.

- (b) a Consumer Disputes Redressal Commission to be known as the 'State Commission' established by the State Government in the State by notification; and
- (c) a National Consumer Disputes Redressal Commission established by the Central Government by notification.

10. Composition of the District Forum.—(1) Each District Forum shall consist of,—

- (a) a person who is, or has been, or is qualified to be a District Judge, who shall be its President;
- (b) two other members, one of whom shall be a woman, who shall have the following qualifications, namely:—
 - (i) be not less than thirty-five years of age,
 - (ii) possess a bachelor's degree from a recognised university,
 - (iii) be persons of ability, integrity and standing, and have adequate knowledge and experience of at least ten years in dealing with problems relating to economics, law, commerce, accountancy, industry, public affairs or administration:

(1A) Every appointment under sub-section (I) shall be made by the State Government on the recommendation of a selection committee consisting of the following, namely:—

Provided that where the President of the State Commission is, by reason of absence or otherwise, unable to act as Chairman of the Selection Committee, the State Government may refer the matter to the Chief Justice of the High Court for nominating a sitting Judge of that High Court to act as Chairman.

11. Jurisdiction of the District Forum.—(1) Subject to the other provisions of this Act, the District Forum shall have jurisdiction to entertain complaints where the value of the goods or services and the compensation, if any, claimed "does not exceed rupees twenty lakhs.

12. Manner in which complaint shall be made.—(1) A complaint in relation to any goods sold or delivered or agreed to be sold or delivered or any service provided or agreed to be provided may be filed with a District Forum by –

- (a) the consumer to whom such goods are sold or delivered or agreed to be sold or delivered or such service provided or agreed to be provided;
- (b) any recognised consumer association whether the consumer to whom the goods sold or delivered or agreed to be sold or delivered or service provided or agreed to be provided is a member of such association or not;
- (c) one or more consumers, where there are numerous consumers having the same interest, with the permission of the District Forum, on behalf of, or for the benefit of, all consumers so interested; or
- (d) the Central Government or the State Government, as the case may be, either in its individual capacity or as a representative of interests of the consumers in general.

(2) Every complaint filed under sub-section (1) shall be accompanied with such amount of fee and payable in such manner as may be prescribed.

(3) On receipt of a complaint made under sub-section (1), the District Forum may, by order, allow the complaint to be proceeded with or rejected:

Provided that a complaint shall not be rejected under this section unless an opportunity of being heard has been given to the complainant:

Provided further that the admissibility of the complaint shall ordinarily be decided within twenty-one days from the date on which the complaint was received.

(4) Where a complaint is allowed to be proceeded with under sub-section (3), the District Forum may proceed with the complaint in the manner provided under this Act:

Provided that where a complaint has been admitted by the District Forum, it shall not be transferred to any other court or tribunal or any authority set up by or under any other law for the time being in force.

Explanation.- For the purpose of this section "recognised consumer association" means any voluntary consumer association registered under the Companies Act, 1956 or any other law for the time being in force".

13. Procedure on admission of complaint.—

(2) the District Forum shall, if the complaint admitted by it under section 12 relates to goods in respect of which the procedure specified in sub-section (1) cannot be followed, or if the complaint relates to any services,—

- (a) refer a copy of such complaint to the opposite party directing him to give his version of the case within a period of thirty days or such extended period not exceeding fifteen days as may be granted by the District Forum;
- (b) where the opposite party, on receipt of a copy of the complaint, referred to him under clause (a) denies or disputes the allegations contained in the complaint, or omits or fails to take any action to represent his case within the time given by the District Forum, the District Forum shall proceed to settle the consumer dispute,—

- (i) on the basis of evidence brought to its notice by the complainant and the opposite party, where the opposite party denies or disputes the allegations contained in the complaint, or
- (ii) ex parte on the basis of evidence brought to its notice by the complainant where the opposite party omits or fails to take any action to represent his case within the time given by the Forum.
- (c) where the complainant fails to appear on the date of hearing before the District Forum, the District Forum may either dismiss the complaint for default or decide it on merits.

(3) No proceedings complying with the procedure laid down in subsections (1) and (2) shall be called in question in any court on the ground that the principles of natural justice have not been complied with.

(3A) Every complaint shall be heard as expeditiously as possible and endeavour shall be made to decide the complaint within a period of three months from the date of receipt of notice by opposite party where the complaint does not require analysis or testing of commodities and within five months if it requires analysis or testing of commodities:

Provided that no adjournment shall be ordinarily granted by the District Forum unless sufficient cause is shown and the reasons for grant of adjournment have been recorded in writing by the Forum:

Provided further that the District Forum shall make such orders as to the costs occasioned by the adjournment as may be provided in the regulations made under this Act.

(4) For the purposes of this section, the District Forum shall have the same powers as are vested in a civil court under Code of Civil Procedure, 1908 while trying a suit in respect of the following matters, namely:—

- (i) the summoning and enforcing the attendance of any defendant or witness and examining the witness on oath;
- (ii) the discovery and production of any document or other material object producible as evidence;
- (iii) the reception of evidence on affidavits;
- (iv) the requisitioning of the report of the concerned analysis or test from the appropriate laboratory or from any other relevant source;
- (v) issuing of any commission for the examination of any witness, and
- (vi) any other matter which may be prescribed.

14. Finding of the District Forum.—(1) If, after the proceeding conducted under section 13, the District Forum is satisfied that the goods complained against suffer from any of the defects specified in the complaint or that any of the allegations contained in the complaint about the services are proved, it shall issue an order to the opposite party directing him to do one or more of the following things, namely:—

- (a) to remove the defect pointed out by the appropriate laboratory from the goods in question;
 - (b) to replace the goods with new goods of similar description which shall be free from any defect;
 - (c) to return to the complainant the price, or, as the case may be, the charges paid by the complainant;
 - (d) to pay such amount as may be awarded by it as compensation to the consumer for any loss or injury suffered by the consumer due to the negligence of the opposite party.
- Provided that the District Forum shall have the power to grant punitive damages in such circumstances as it deems fit;
- (e) to remove the defects in goods or deficiencies in the services in question;
 - (f) to discontinue the unfair trade practice or the restrictive trade practice or not to repeat it;
 - (g) not to offer the hazardous goods for sale;
 - (h) to withdraw the hazardous goods from being offered for sale;
 - (ha) to cease manufacture of hazardous goods and to desist from offering services which are hazardous in nature;

(hb) to pay such sum as may be determined by it if it is of the opinion that loss or injury has been suffered by a large number of consumers who are not identifiable conveniently:

Provided that the minimum amount of sum so payable shall not be less than five per cent. of the value of such defective goods sold or service provided, as the case may be, to such consumers:

Provided further that the amount so obtained shall be credited in favour of such person and utilized in such manner as may be prescribed;

(hc) to issue corrective advertisement to neutralize the effect of misleading advertisement at the cost of the opposite party responsible for issuing such misleading advertisement;

(i) to provide for adequate costs to parties.

(2A) Every order made by the District Forum under sub-section (1) shall be signed by its President and the member or members who conducted the proceeding:

Provided that where the proceeding is conducted by the President and one member and they differ on any point or points, they shall state the point or points on which they differ and refer the same to the other member for hearing on such point or points and the opinion of the majority shall be the order of the District Forum.

16. Composition of the State Commission.—(1) Each State Commission shall consist of—

(a) a person who is or has been a Judge of a High Court, appointed by the State Government, who shall be its President:

Provided that no appointment under this clause shall be made except after consultation with the Chief Justice of the High Court; [...]

17. Jurisdiction of the State Commission.—(1) Subject to the other provisions of this Act, the State Commission shall have jurisdiction—

(a) to entertain—

(i) complaints where the value of the goods or services and compensation, if any, claimed exceeds rupees twenty lakhs but does not exceed rupees one crore; and

(ii) appeals against the orders of any District Forum within the State; and

(b) to call for the records and pass appropriate orders in any consumer dispute which is pending before or has been decided by any District Forum within the State, where it appears to the State Commission that such District Forum has exercised a jurisdiction not vested in it by law, or has failed to exercise a jurisdiction so vested or has acted in exercise of its jurisdiction illegally or with material irregularity.

20. Composition of the National Commission.—(1) The National Commission shall consist of—

(a) a person who is or has been a Judge of the Supreme Court, to be appointed by the Central Government, who shall be its President;

Provided that no appointment under this clause shall be made except after consultation with the Chief Justice of India; [...]

21. Jurisdiction of the National Commission.—Subject to the other provisions of this Act, the National Commission shall have jurisdiction—

(a) to entertain—

(i) complaints where the value of the goods or services and compensation, if any, claimed exceeds rupees one crore; and

(ii) appeals against the orders of any State Commission; and

(b) to call for the records and pass appropriate orders in any consumer dispute which is pending before or has been decided by any State Commission where it appears to the National Commission that such State Commission has exercised a jurisdiction not vested in it by law, or has failed to exercise a jurisdiction so vested, or has acted in the exercise of its jurisdiction illegally or with material irregularity.

27. Penalties.—(1) Where a trader or a person against whom a complaint is made or the complainant fails or omits to comply with any order made by the District Forum, the State Commission or the National Commission, as the case may be, such trader or person or complainant shall be punishable with imprisonment for a term which shall not be less than one month but which may extend to three years, or with fine which shall not be less than two thousands rupees but which may extend to ten thousand rupees, or with both:

(3) All offences under this Act may be tried summarily by the District Forum or the State Commission or the National Commission, as the case may be.

CHAPTER IV

MISCELLANEOUS

30A. (1) The National Commission may, with the previous approval of the Central Government, by notification, make regulations not inconsistent with this Act to provide for all matters for which provision is necessary or expedient for the purpose of giving effect to the provisions of this Act.

(2) In particular and without prejudice to the generality of the foregoing power, such regulations may make provisions for the cost of adjournment of any proceeding before the District Forum, the State Commission or the National Commission, as the case may be, which a party may be ordered to pay.

31. Laying of rules.-- (1) Every rule and every regulation made under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the rule or regulation or both Houses agree that the rule or regulation should not be made, the rule or regulation shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule or regulation.

(2) Every rule made by a State Government under this Act shall be laid as soon as may be after it is made, before the State Legislature

THE MF BILL, 2011 (SELECTED PROVISIONS)

A BILL to provide access to financial services for the rural and urban poor and certain disadvantaged sections of the people by promoting the growth and development of micro finance institutions as extended arms of the banks and financial institutions and for the regulation of micro finance institutions and for matters connected therewith and incidental thereto.

WHEREAS the banking system has achieved significant growth in terms of average population per bank office and has been able to reduce the levels of credit gaps in the economy;

AND WHEREAS inspite of such growth many of the poor households still do not have access to basic financial services such as savings, credit and money transfer and the financial exclusion faced by such people results in discrimination and denial of equal opportunities to them;

AND WHEREAS micro finance sector is engaged in providing credit and other financial services to the poor households and their micro enterprises as an extended arm of the banking system;

AND WHEREAS micro finance sector lacks a formal statutory framework for its financial activities;

NOW THEREFORE it is expedient to provide a formal statutory framework for the promotion, development, regulation and orderly growth of the micro finance sector and thereby to facilitate universal access to integrated financial services for the unbanked population.

BE it enacted by Parliament in the Sixty Second Year of the Republic of India as follows: -

CHAPTER I PRELIMINARY

1.(1) This Act may be called the Micro Finance Institutions (Development and Regulation) Act, 2011

(2) It shall come into force on such date as the Central Government may, by notification in the Official gazette, appoint:

Provided that different dates may be appointed for different provisions of this Act and any reference in such provision to the commencement of this Act shall be construed as a reference to the coming into force of that provision.

2. In this Act, unless the context otherwise requires, -

(a) “annual percentage rate” means aggregate rate consisting of interest, processing fees, service charges and any other charges or fees charged by the micro finance institution on any financial assistance granted to any client;

(b) “co-operative society” means a society or cooperative registered or deemed to be registered, under the Cooperative Societies Act, 1912 or any other Central or State law relating to cooperative societies or cooperatives for the time being in force;

(c) “Council” means the Micro Finance Development Council constituted under section 3;

(d) “financial assistance” means any loan, advance, grant or any guarantee given or any other credit facility extended in cash or kind with or without security or guarantee;

(e) “margin” means the difference between the annual percentage rate collected by the micro finance institution for any financial assistance granted to clients and the cost of funds raised and other operational costs incurred by the micro finance institution for grant of and servicing such financial assistance.

(f) “micro finance institution” means an entity (irrespective of its organisational form), which provides micro finance services in the form and manner as may be prescribed but does not include: -

(i) a banking company, State Bank of India, a Subsidiary Bank, a corresponding new bank, a cooperative bank, EXIM Bank, Reconstruction Bank, National Housing Bank, National Bank, a Regional Rural Bank and Small Industries Bank;

(ii) a co-operative society engaged primarily in agricultural operations or industrial activity or purchase or sale of any goods and such other activities;

(iii) a cooperative society not accepting deposits from anybody except from its members having voting rights or from those members who will acquire voting rights after a stipulated period of their making deposits as per the law applicable to such

cooperative society.

(g) “Micro finance services” means one or more of the following financial services involving small amounts to :

individuals or groups:

- (i) providing micro credit;
- (ii) collection of thrift;
- (iii) remittance of funds;
- (iv) providing pension or insurance services;
- (v) any other services as may be specified.

in such form and manner as may be prescribed.

(h) “National Bank” means the National Bank for Agriculture and Rural Development established under section 3 of the National Bank for Agriculture and Rural Development Act, 1981;

(l) “regulations” means regulations made by the Reserve Bank;

(o) “Systemically important micro finance institution” means a micro finance deploying such amount of funds for providing micro credit to such minimum number of clients as may be specified by the Reserve Bank by regulations framed under this Act.

(p) “thrift” means any money collected other than in the form of current account or demand deposits, by a micro finance institution from members of self-help groups or any other group of individuals by whatever name called, who are availing financial services provided by such micro finance institution;

CHAPTER II

MICRO FINANCE DEVELOPMENT COUNCIL

3. The Central Government may, by notification, constitute a Council to be known as the Micro Finance Development Council, to advise the Central Government, on formulation of policies, schemes and other measures required in the interest of orderly growth and development of the micro finance sector and micro finance institutions, to promote financial inclusion.

4. The Council shall consist of the following members, nominated by the Central Government namely:

- (a) a person of eminence, with experience in banking, rural credit and micro finance, - Chairperson;
- (b) two officers, not below the rank of Joint Secretary to the Government of India, one each from the Ministry of Finance and the Ministry of Rural Development – Members;
- (c) an officer, not below the rank of an Executive Director of the Reserve Bank - Member;
- (d) an officer, not below the rank of an Executive Director of the Small Industries Development Bank of India established under the Small Industries Development Bank of India Act, 1989 - Member;
- (e) an officer, not below the rank of an Executive Director of the National Bank dealing with micro finance, - Member;
- (f) an officer, not below the rank of an Executive Director of the National Housing Bank established under the National Housing Bank Act, 1987– Member;
- (g) not more than six persons, of whom at least two shall be women, to be nominated in consultation with the Reserve Bank from amongst persons with experience in banking, rural credit and micro finance or the representatives of micro finance institutions or scheduled banks or any other institution providing micro finance services - Members.

5. The Council shall advise the Central Government on formulation of policies and measures including;

- (i) adoption of any innovations and use of technology in providing micro finance services;
- (ii) establishing credit information bureaus for creation of data-base of clients availing micro finance services from various agencies;
- (iii) the working of grievance redressal mechanisms and suggest modifications of the systems to protect the interest of clients of micro finance services; or
- (iv) any other matter which may be referred to the Council by the Central Government in the interest of promotion of financial inclusion and protecting the interest of clients availing micro finance services

6. A member of the Council shall hold office for such term not exceeding three years as the Central

Government may fix, and, receive such fees and allowances as may be prescribed.

CHAPTER III

STATE ADVISORY COUNCILS

8. (1) The Central Government may by issue of a notification establish State Advisory Councils for Micro Finance at the State level and considering the extent of micro finance activities in the States, such Advisory Councils may be set up with jurisdiction over more than one State.

(2) The constitution of such State Advisory Councils shall be as under:

- (a) two Nominees of the concerned State or States including a Chairperson of the Advisory Council;
- (b) Convener Bank of the State Level Bankers' Committee for any State or States;
- (c) one member representing the micro finance sector operating in the State nominated by the Central Government; and
- (d) one member nominated by the Reserve Bank.

(3) The State Advisory Councils shall advise the Central Government the progress achieved in implementation of the Policy initiatives undertaken for promotion and development of the micro finance sector in the State including the following matters:

- (a) whether lending activities undertaken by micro finance institutions is resulting in over-indebtedness and consequent large scale defaults;
- (b) whether recovery practices adopted by micro finance institutions are fair and reasonable;
- (c) whether the grievance redressal mechanism is working satisfactorily;
- (d) overall assessment of the impact of measures for financial literacy and inclusion on an annual basis;
- (e) any other matter which the State Advisory Council deems necessary to bring to the notice of Central Government.

(4) The Central Government may entrust such other functions of the Micro Finance Development Council to any State Advisory Council by issue of notification subject to such terms and conditions as deemed fit.

9. A member of the Council shall hold office for such term not exceeding three years and receive such fees and allowances may be prescribed.

CHAPTER IV

REGISTRATION OF MICRO FINANCE INSTITUTIONS

10. Notwithstanding anything contained in the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 and save as otherwise provided in this Act, no micro finance institution shall commence or carry on the activity of providing micro finance services without obtaining a certificate of registration from the Reserve Bank under this Act.

11. (1) A micro finance institution which intends to commence the business of providing micro finance services shall make an application for registration to the Reserve Bank in such form and manner along with such fee as may be specified by regulations.

(2) Any micro finance institution, in existence at the commencement of this Act engaged in providing micro finance services shall, before the expiry of three months from such commencement, apply in writing to the Reserve Bank for a certificate of registration under this Act.

(3) Any company registered as a non-banking finance company with the Reserve Bank of India under the provisions of chapter III-B of the Reserve Bank of India, 1934, and engaged in the activity of extending micro finance services shall also apply for registration as a micro finance institution under this Act.

(4) Any such non-banking finance company registered as micro finance institution under this Act, shall continue to comply with the terms and conditions of its registration and any rules, regulations, directives and guidelines issued by the Reserve Bank to the non-banking finance companies, from time to time and such other rules, regulations, directives and guidelines of the Reserve Bank as may be issued by the Reserve Bank for the micro finance institutions, under this Act.

12. (1) The Reserve Bank may, for the purpose of grant of certificate of registration, satisfy itself that the following conditions are fulfilled by the applicant micro finance institution, namely:—

- (a) the general character and management of the applicant shall not be prejudicial to the interest of the clients availing micro finance services.;

- (b) the applicant is engaged in the promotion and development of financial inclusion by providing micro finance services;
- (c) the applicant has a net owned fund, created out of contributions to capital, reserves or grants or donations received by it, of at least five lakh rupees or such other amounts specified by regulations;
- (d) any other condition as may be specified by regulations .

(2) The Reserve Bank may, on being satisfied that the conditions referred to in sub-section (1) are fulfilled, grant a certificate of registration to the applicant micro finance institution to commence or carry on the business of providing micro finance services subject to such conditions as it may consider necessary to impose:

Provided that no application for registration shall be rejected unless the applicant has been given an opportunity of being heard.

13. Cease and desist order

(1) If on inspection or perusal of annual accounts or any returns submitted by any micro finance institution, the Reserve Bank is satisfied that activities of any micro finance institution are being conducted in a manner prejudicial to the interest of its clients or depositors or the micro finance institution itself the Reserve Bank may pass an order directing such micro finance institution to cease and desist from continuing the micro finance activities subject to such terms and conditions as may be specified in such order.

(2) The Reserve Bank may, subject to such conditions as may be prescribed, grant time to such Micro Finance Institution for taking necessary steps to comply with such directives or conditions within the time granted by the Reserve Bank.

(3) The Reserve Bank may withdraw the Cease and Desist Order issued under sub-section (1) if the Reserve Bank is satisfied that Micro Finance Institution has complied with the directives and other terms of the Order.

(4) The Reserve Bank may initiate proceedings for cancellation of the registration granted to the micro finance institution if it fails to comply with, and implement the directives or conditions stipulated by Reserve Bank in the Cease and desist Order.

14.(1) The Reserve Bank may cancel the certificate of registration granted to a micro finance institution under section 12, if such micro finance institution,—

- (i) fails to comply with directives or condition stipulated with Cease and desist Order passed under section 13 by the Reserve Bank;
- (ii) ceases to carry on the business of providing micro finance services or
- (iii) has failed to comply with any of the conditions including conditions relating to maintenance of the levels of assets deployed and observance of other norms subject to which the certificate of registration has been granted to it; or
- (iv) fails to comply with any direction issued by the Reserve Bank under the provisions of this Act; or
- (iv) fails to submit or offer for inspection its books of accounts and other relevant documents under sub-section (2) of section 26.

(2) Before cancelling the certificate of registration under this section, the Reserve Bank shall provide an opportunity to such a micro finance institution to show cause why the certificate or registration granted to it should not be cancelled.

(3) Any such representation made by the Micro Finance Institution shall be considered by the Reserve Bank and an order recording the reasons either for withdrawal of the cancellation or confirming the cancellation shall be passed by the Reserve Bank within 60 days of the representation.

15 (1) Any micro finance institution which is not a company registered under the Companies Act, 1956 and which becomes systemically important micro finance institution shall convert its institution into a company registered under the Companies Act, 1956 with or without a licence under section 25 of the Companies Act, 1956, within six months from the date of the Balance Sheet which shows that it has become systematically important micro finance institution in terms of the rules prescribed by the Central Government.

(2) A micro finance institution which becomes systemically important shall submit to the Reserve Bank a certificate from the Statutory Auditor indicating the Assets pattern and total number of clients availing micro finance services making it eligible to be classified as systemically important micro

finance institution, within one month from the date of finalisation of the balance sheet.

(3) On becoming systemically important micro finance institution it shall comply with any directives issued by the Reserve Bank, from time to time to systemically important micro finance institutions.

16 (1) A micro finance institution aggrieved by an order of rejection of an application for grant of certificate of registration under section 12, or cancellation of certificate of registration under section 14, or any action taken by the Reserve Bank under sub-section (4) of section 26, may prefer an appeal to the Central Government or such other authority as the Central Government may, by notification specify, within a period of sixty days from the date on which such order is communicated to the micro finance institution.

CHAPTER IV

RESERVE, ACCOUNTS, AUDIT AND RETURNS

17. (1) Every micro finance institution registered with the Reserve Bank under this Act shall create a reserve fund and transfer therein a sum, representing such percentage, as may be specified by the Reserve Bank, of its net profit or surplus realized by providing micro finance services every year as disclosed in the profit and loss account or income and expenditure account before any dividend is declared or surplus is utilized for any other purpose.

(2) No appropriation of any sum from the reserve fund shall be made by the micro finance institution except for the purpose, as may be specified by the Reserve Bank from time to time, and every such appropriation shall be reported to the Reserve Bank within twenty-one days from the date of such appropriation.

(3) The Reserve Bank may, in the public interest or in the interest of clients of any micro finance institution direct any micro finance institution or any class of micro finance institutions to invest the whole or part of such reserve fund in such unencumbered securities, as it may, by regulations specify.

18. At the close of each financial year, every micro finance institution shall prepare with reference to that year, in respect of all services transacted by it, a balance sheet, profit and loss account or an income and expenditure account as on the last working day of the financial year, in such forms as may be specified by regulations.

19. The balance sheet, profit and loss account or an income and expenditure account prepared in accordance with section 18 shall be audited by a person duly qualified under any law for the time being in force to be an auditor of companies formed and registered under the Companies Act, 1956 or an auditor from the list of Chartered Accountants or other qualified persons approved by the Reserve Bank

20. Without prejudice to anything contained in the Companies Act, 1956 or any other law for the time being in force, where the Reserve Bank is of the opinion that it is necessary in the public interest or in the interest of its clients or for the purpose of proper assessment of the records and books of account of the micro finance institution, so to do, it may by order direct –

- (a) the auditor of micro finance institution to audit the accounts of the micro finance institution in relation to any transaction or class of transactions, or for such period or periods as may be specified in the order, and the auditor shall comply with such directions and make a report of the audit with such information as it may be asked to report by the Reserve Bank to it and forward a copy thereof to the micro finance institution;
- (b) such micro finance institution to appoint auditors, with the prior approval of the Reserve Bank, for such period and subject to such conditions as the Reserve Bank may specify from time to time.

CHAPTER V

FUNCTIONS AND POWERS OF RESERVE BANK

23. (1) It shall be the duty of the Reserve Bank to promote and ensure orderly growth of the micro finance Sector in accordance with such measures as it deems fit, for the purpose of promoting financial inclusion.

(2) Without prejudice to the generality of the foregoing provisions contained in sub-section (1), the measures may provide for-

- (a) formulating and facilitating appropriate policy for the orderly growth of the micro finance services provided by micro finance institutions so as to ensure greater transparency, effective management, good governance and to facilitate the flow of micro finance services in an efficient manner;

- (b) setting or facilitating the sector related benchmarks and performance standards pertaining to methods of operation, methods of recovery, management and governance including model codes for conduct of business of micro finance institutions;
- (c) facilitating the development of credit rating norms or rating norms for other purposes for micro finance institutions;
- (d) specifying the form and manner of books of account to be maintained by micro finance institutions;
- (e) specifying the form and manner of accounting of business operations of micro finance institutions and auditing standards relating thereto;
- (f) calling for information and data from micro finance institutions for maintaining an appropriate data base in the public domain relating to micro finance services and disseminating the same through a national dissemination network;
- (g) facilitating institutional development of all entities, including groups, engaged in micro finance services through training and capacity building measures;
- (h) promoting customer education of all entities engaged in thrift services and micro finance for greater awareness and for economic empowerment of micro finance clients;
- (i) supporting sector related research, field research, documentation and dissemination thereof;
- (j) co-ordinating with other agencies for orderly growth and development of entities engaged in the micro finance services;
- (k) documenting and disseminating information relating to fair practices with a view to ensuring provision of thrift services and micro finance services at an affordable cost to eligible clients;
- (l) perform such other functions as may be prescribed.

24. (1) If the Reserve Bank is satisfied that, in the public interest or to prevent the affairs of any micro finance institution being conducted in a manner detrimental to the interest of the clients availing micro finance services or in a manner prejudicial to the interest of the micro finance institution, it is necessary or expedient so to do, it may give directions to a class or classes or all micro finance institutions relating to income recognition, accounting standards, making of proper provision for bad and doubtful debts, capital adequacy based on risk weights for assets and credit conversion factors for off-balance-sheet items and also relating to deployment of funds by a micro finance institution or a class of micro finance institutions or micro finance institutions generally, as the case may be, and such micro finance institutions shall be bound to follow the policy so determined and the directions so issued.

(2) In particular and without prejudice to the generality of the foregoing powers, such directions may provide for all or any of the following matters, namely: -

- (a) extent of deployment of assets for providing micro finance services and proportion of clients availing such services , necessary to classify any institution as Micro finance institution;
- (b) ceiling on amount of financial assistance and the number of individual clients to whom such financial assistance may be provided by any micro finance institution;
- (c) tenure of financial assistance given to clients and other terms such as purpose for which financial assistance can be given, margin caps and periodicity of repayment schedules;
- (d) levy of processing fees, interest, life insurance premium and other terms relating to financial assistance and the percentage of margin to be maintained by a micro finance institution.
- (e) specify the maximum Annual Percentage Rate that can be charged by a micro finance institution on the financial assistance granted to any client.
- (f) specify the locations where financial assistance may be sanctioned and disbursed by micro finance institutions;
- (g) require micro finance institutions to become members of Credit Information Bureaus that may be set up for the Micro Finance Sector;
- (h) observe Code of Conduct formulated by any Self-Regulatory Organisation of micro finance institutions recognized by the Reserve Bank and set up grievance redressal mechanism for their clients as required by the self-regulatory organisation;
- (i) provide a Client Protection Code and direct its acceptance and observance by micro finance

institutions ;

(j) advise micro finance institutions to achieve better control , simplification of procedures and reduction of costs by use of information technology;

(k) specify the minimum net-worth of micro finance institutions considering their size of operations and other relevant parameters;

(l) specify norms for corporate governance to be observed by micro finance institutions;

(m) specify prudential norms relating to income recognition, accounting standards, provisioning for bad and doubtful debts, capital adequacy based on risk weights for assets and deployment of funds;

(n) require disclosure of assignments or securitisation of assets as also assets assigned with recourse or with arrangement as agent for collection of loan installments;

(o) raising of preference share capital or other capital by micro finance institution;

(p) grant recognition to any self Regulatory Organisation of micro finance institutions;

(q) generally for efficient conduct of the business of micro finance institution.

25. (1) A micro finance institution engaged in the activity of granting financial assistance to eligible clients shall maintain the percentage of margin as may be specified by the Reserve Bank by regulations from time to time.

Explanation: The Reserve Bank may specify margin under sub-section (1) for micro finance institutions generally or for a class of micro finance institutions or for any micro finance institution in particular, considering the size of their operations and other relevant parameters.

(2) A micro finance institution engaged in the activity referred in sub-section (1) shall convey to every borrower the annual percentage rate comprising of the annual interest rate, processing fees or any other charges or fees levied by the micro finance institution and incorporate the same distinctly and prominently in the loan document obtained from the borrower as also in the sanction letter given to the borrower.

(3) A micro finance institution shall also obtain from the Statutory Auditors a certificate that the margin available to and realised by the micro finance institution does not exceed the percentage of margin specified by the Reserve Bank computed on the basis of the annual percentage rate fixed by the micro finance institution and that the micro finance institution has complied with the requirements of sub-sections (1) and (2)

26. (1) The Reserve Bank may, at any time, cause inspection to be made of books of account or any other record of any micro finance institution, by an inspecting authority approved by it in such manner and on such terms and conditions as may be specified by it and such inspecting authority shall submit a report to the Reserve Bank in respect of inspection made by it.

(2) It shall be duty of every person who is a director, trustee or a member of Managing Committee, manager, secretary or other officer or employee of the micro finance institution to produce before the inspecting authority, all such books of account, records and other documents in custody or power of the person to furnish any statement or information relating to affairs of the micro finance institution, as the inspecting authority may require within such time, as may be specified.

(3) A copy of the report under sub-section (1) shall be furnished to the micro finance institution, if:

(a) the micro finance institution makes a request for the same; or

(b) any action is contemplated against the micro finance organization on the basis of such report.

(4) If the Reserve Bank, after considering the report, is of the view that the affairs of any micro finance institution are being conducted to the detriment of its clients, it may after giving such opportunity to the micro finance institution to make representation in connection with the report, take such action as it deems appropriate including removal of any officer, office bearer or managing committee of the micro finance institution or prohibiting the micro finance institution from providing micro finance services for such period as the Reserve Bank may deems fit, in accordance with the procedure specified in the regulations.

27. No micro finance institution providing micro finance services or other services, shall close or wind up its business, or amalgamate with other institutions, or take over any other business or its shareholding or de-merge or divide, or restructure, or otherwise transfer the ownership or control of its business without prior approval of the Reserve Bank. ering the report, is of the view that the affairs of any micro finance institution are being conducted to the detriment of its clients, it may after giving

such opportunity to the micro finance institution to make representation in connection with the report, take such action as it deems appropriate including removal of any officer, office bearer or managing committee of the micro finance institution or prohibiting the micro finance institution from providing micro finance services for such period as the Reserve Bank may deems fit, in accordance with the procedure specified in the regulations.

28. Power of Reserve Bank to file winding up petition

(1) The Reserve Bank, on being satisfied that a micro finance institution

- (a) is unable to pay its debt; or
- (b) by virtue of provisions of this Act become disqualified to carry on the activity of micro finance institution; or
- (c) has failed to comply with any directives or orders issued by the Reserve Bank along with the Cease and Desist Order or otherwise; or
- (d) the continuance of the micro finance institution is detrimental to public interest or to the interest of the clients of the institution;

may file an application for winding up or any other application by whatever name called, before the appropriate authority or Court empowered to wind up the business or activity of the micro finance institution under the law applicable to such micro finance institution.

Explanation: If the micro finance institution against whom application for winding up is to be filed is also engaged in any other activity, the concerned micro finance institution may be permitted to continue such activity and restrict the winding up or closure of the business only to the activity of providing micro finance services with the approval of the concerned authority or Court.

(2) A micro finance institution shall be deemed to be unable to pay its debts if it has refused or has failed to meet within five working days any lawful demand made at any of its officers or branches and the Reserve Bank certifies in writing that such company is unable to pay its debt.

CHAPTER VI

CONSTITUTION OF MICRO FINANCE DEVELOPMENT FUND

29. The Central Government may, after due appropriation made by Parliament by law in this behalf, make to the Reserve Bank, National Bank or any other authority s may be prescribed, grant such sums of money as that Government may think fit for being utilised for the purposes of this Act.

30. (1) The Reserve Bank shall constitute a fund to be called the Micro Finance Development Fund (hereafter called 'the Fund') and there shall be credited thereto -

- (a) all Government grants received and fees payable under this Act;
- (b) all sums that may be raised by the Reserve Bank from donors, Governments, institutions, other entities and public for the purpose of this Act;
- (c) any interest or other income received out of investments made from the Fund under clause (c) of sub-section (3);
- (d) the balance outstanding in the Micro Finance Development and Equity Fund maintained by the Reserve Bank, before the commencement of this Act.

(2) The Fund shall be managed by the Reserve Bank in the in accordance with regulations duly approved by the Central Board of Directors of the Reserve Bank.

(3) The Fund shall be applied-

- (a) to provide loans, refinance, grant, seed capital or any other financial assistance to any micro finance institution or any other agency which the Reserve Bank may by regulations specify;
- (b) to give grants or loans for training and capacity building of institutions engaged in micro finance services and personnel engaged in promoting and providing micro finance services and meeting other expenditure related to such training and capacity building on such terms and conditions as may be specified by regulations;
- (c) to invest in equity or any other form of capital or quasi-equity of a micro finance institution or any other agency on such terms and conditions as may be specified by regulations;
- (d) to meet the expenses in relation to collection, analysis, dissemination of information relating to micro finance, conduct of such research, experiments or studies as may be necessary, and to design, promote, and propagate such practices as may be considered conducive to the growth of micro finance services;

- (e) to meet any other expenses as may be required for the promotion of micro finance services as the Reserve Bank by regulations specify;
- (f) to meet any other expenses (except salaries, allowances and other remuneration of officers and other employees) of the Reserve Bank in connection with discharge of its functions as may be specified by the regulations.

CHAPTER VII REDRESSAL MECHANISM

31. (1) The Reserve Bank may, in consultation with the Micro Finance Development Council and the State Advisory Councils, if deemed necessary, appoint as many Micro Finance Ombudsmen as it may deem fit in accordance with a scheme framed under this section, for the purpose of redressal of grievances between clients of micro finance institutions and micro finance institutions with powers to issue directions to micro finance institutions.

(2) Any such scheme of Micro Finance Ombudsman may provide for the following:-

- (a) appointment, terms of office, conditions of service and location of office of the Ombudsman;
- (b) nature of grievances and complaints that may be entertained by the Ombudsman and the procedures for redressal of grievances and complaints;
- (c) any other matter that may be necessary for effective functioning of Micro Finance Ombudsman.

CHAPTER VIII OFFENCES AND PENALTIES

32. (1) If any provision of this Act is contravened or if any default is made in complying with any other requirement of this Act or of any rules, regulations or orders or directions given or notification issued or condition imposed thereunder, any person guilty of such contravention or default shall be punishable with fine which may extend to five lakh rupees and where, a contravention or default is a continuing one, with further fine, which may extend to ten thousand rupees for everyday after the first, during which the contravention or default continues or with imprisonment for a term not exceeding two years or with both.

(2) Whoever knowingly fails to comply with the provisions of section 12 or any orders made by the Central Government or other specified authority under section 13 or the directions issued by the Micro Finance Ombudsman shall be punishable with fine which may extend to five lakh rupees and where, a contravention or default is a continuing one, with a further fine, which may extend to ten thousand rupees for every day after the first, during which the contravention or default continues, or with imprisonment for a term not exceeding two years or with both.

(3) Every offence connected with or arising out of acceptance of thrift or repayment thereof, shall be a cognizable offence under the Code of Criminal Procedure, 1973.

33. Whoever, in any application, declaration, return, statement, information or particulars made, required or furnished by or under or for the purposes of any provision of this Act, or any rule, regulation or order or direction made or given there under, willfully makes a statement which is false in any material particulars knowing it to be false or willfully omits to make a material statement, shall be punishable with imprisonment for a term which may extend to two years and shall also be liable to fine which may extend to five lakh rupees and where, a contravention or default is a continuing one, with further fine, which may extend to ten thousand rupees for everyday after the first, during which the contravention or default continues or with imprisonment for a term not exceeding two years or with both.

34. (1) Notwithstanding anything to the contrary contained in sections 27 and 28, the Reserve Bank may impose penalty,—

- (a) which may extend upto five lakhs rupees where the contravention is of the nature referred to in sections 26 and 27;
- (b) which may not be less than ten thousand rupees for every day during which non compliance of the orders and directions, referred to in sections 28 and 29 continues.

(2) For the purpose of imposing penalty under sections 29 and 30, the Reserve Bank shall serve notice on the micro finance institution requiring it to show cause why the amount specified in the notice should not be imposed as a penalty and a reasonable opportunity of being heard shall also be given to such micro finance institution.

(3) Any penalty imposed by the Reserve Bank under this section shall be payable within a period of thirty days from the date on which the notice by the Reserve Bank demanding payment of the amount is served on the micro finance institution to pay the amount and the orders of the Reserve Bank shall be enforceable in the same manner as if it were a decree made by the civil court in a civil suit.

36. (1) Where an offence under this Act is committed, the person who was in charge of, and was responsible to, the micro finance institution for the conduct of business of the micro finance institution, as well as the micro finance institution itself, shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly:

Provided that nothing contained in this sub-section shall render any such person liable to punishment if he proves that the contravention or default was committed without his knowledge or that he had exercised all due diligence to prevent the commission of such offence.

(2) Notwithstanding anything contained in sub-section (1), where an offence under this Act has been committed by a micro finance institution and it is proved that the same was committed with the consent or connivance of, or is attributable to any neglect on the part of, any person who is or was a director, trustee, member of the managing committee, manager, secretary or other officer or employee of the micro finance institution when the offence is or was committed, such person shall also be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly.

Explanation— For the purposes of this section, any offence punishable under this Act shall be deemed to have been committed at the place where the registered office or principal office of the micro finance institution, is situated.

CHAPTER IX DELEGATION OF POWERS

38. (1) The Reserve Bank may with the previous approval of the Central Government delegate any of its powers conferred under this Act to the National Bank in respect of any micro finance institution or a class of micro finance institutions generally, by issue of a notification in the Official Gazette.

(2) Any notification issued under sub-section (1) shall specify the following particulars:

(a) specific micro finance institution or class of micro finance institutions such as companies providing micro finance services for profit or companies licensed under section 25 of the Companies Act, 1956; or other non-corporate organizations engaged in the activity of providing micro finance services or any other category of organizations, to which the delegation of powers shall apply;

(b) the specific powers under various provisions of this Act which are delegated to the National Bank;

(c) the powers which are retained by the Reserve Bank

(3) The National Bank shall exercise the powers delegated by the Reserve Bank subject to such conditions as may be specified in the Notification under sub-section (1) and such directives and guidelines that may be issued by the Reserve Bank from time to time.

(4) Any action taken by the National Bank pursuant to the delegation by the Reserve Bank shall be deemed to be the action of the Reserve Bank and provisions contained in section 17 for appeal against the orders referred in the said section shall lie to the Central Government.

CHAPTER X MISCELLANEOUS

40. The Central Government may, in consultation with the Reserve Bank from time to time, require the furnishing of such returns, statements and such other particulars in regard to micro finance institutions in such form and in such manner as may be prescribed, and the micro finance institution shall furnish to the Central Government such returns, statements and particulars.

41. The Central Government may, on being satisfied that in the public interest, or in the interest of the micro finance institution, it is necessary so to do, by an order published in the Official Gazette, declare that any or all of the provisions of this Act shall not apply to a micro finance institution or a class of micro finance institutions, either generally or for such period as may be specified in the order, subject to such conditions, limitations or restrictions as it may deem fit to impose.

42. The provisions of this Act shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law.

Explanation : For removal of doubts it is declared that micro finance services extended by any micro finance institution registered with the Reserve Bank shall not be treated as money-lender for the purpose of any State enactments relating to money-lenders and usurious loans

44. (1) The Central Government may, by notification in the Official Gazette, make rules for carrying out the provisions of this Act.

(2) In particular, and without prejudice to the generality of the foregoing power, such rules may provide for all or any of the following matters, namely: -

(a) the form and manner of providing micro finance services under clause (g) of section 2 including the following:

(i) the purposes for which financial assistance can be granted

(ii) fix the quantum of financial assistance or other services which will be treated as micro financial services for the purposes of this Act

(iii) declare various categories of clients, households and self-help or joint liability groups who can be provided micro finance services;

(iv) the nature and extent of pension or insurance services that can be provided and the regulatory directives that need to be complied with and observed while providing such services, as may be stipulated by the Pension Regulatory Authority or the Insurance regulatory and Development Authority from time to time;

(v) the maximum amount of thrift that can be collected from each individual client, creation of free reserves in unencumbered securities and any other measures for protecting the interest of the clients keeping thrift with the micro finance institutions;

(vi) various categories of institutions that can provide micro finance services and minimum amount of capital, free reserves or net owned funds any or all or any class or classes of micro finance institutions is required to hold;

(d) the form and manner of collection of thrift by micro finance institutions under clause (p) of section 2;

(i) any other matter which is required to be, or may be, prescribed.

(3) Notwithstanding anything contained in section 45-S of the Reserve Bank of India Act, 1934 the Rules prescribed under clause (d) of sub-section (2) of section 44 may permit acceptance of thrift by micro finance institutions subject to such terms and conditions as may be prescribed.

45. (1) The Reserve Bank, with the previous approval of the Central Government may, by notification in the Official Gazette, make regulations not inconsistent with this Act and the rules made thereunder to carry out the purposes of this Act.

(a) the form and manner in which a micro finance institution shall make an application for registration and the fee payable to the Reserve Bank under sub-section (1) of section 11;

(b) amounts of net owned funds under clause (c) of sub-section (1) of section 12;

(c) any other condition for grant of a certificate of registration under clause (d) of sub-section (1) of section 12;

(d) the unencumbered securities for the purpose of investment under sub-section (3) of section 17;

(e) the form in which the balance sheet, profit and loss account or an income and expenditure account shall be prepared under section 18;

46. Every rule or order made by the Central Government and every regulation made by the Reserve Bank and any order of exemption made under section 41 shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session, for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the rule, regulation, scheme or order or both Houses agree that the rule, regulation, scheme or order should not be made, the rule, regulation or order shall thereafter have effect only in such modified form or be of no effect, as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule, regulation, scheme or order.

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AP MICRO FINANCE INSTITUTIONS (REGULATION OF MONEY LENDING)

ORDINANCE

An Ordinance to protect the women Self Help Groups from exploitation by the Micro Finance Institutions in the State of Andhra Pradesh and for the matters connected therewith or incidental thereto Whereas, Government of Andhra Pradesh has facilitated organization of the below poverty line households into self help groups (SHGs) for the purpose of their economic advancement by achieving financial inclusion through linking with the

banking network;

Whereas these SHGs are being exploited by private Micro Finance Institutions (MFIs) through usurious interest rates and coercive means of recovery resulting in their impoverishment & in some cases leading to suicides, it is expedient to make provisions for protecting the interests of the SHGs, by regulating the money leading transactions by the money lending MFIs and to achieve greater transparency in such transactions in the State of Andhra Pradesh;

And whereas, the Legislature of the State is not now in session and the Governor of Andhra Pradesh is satisfied that circumstances exists which render it necessary for him to take immediate action;

Now, therefore, in exercise of the powers conferred by clause (1) of Article 213 of the Constitution of India, the Governor hereby promulgates the following Ordinance:-

Short title, extent and commencement

1. (1) This Ordinance may be called the Andhra Pradesh Micro Finance Institutions (regulation of money lending) Ordinance, 2010.
- (2) It extends to the whole of the State of Andhra Pradesh.
- (3) It shall come into force at once.
- (4) It shall apply to Micro Finance Institutions whether they had come into existence before or after the commencement of this Ordinance.

Definitions

2. In this Ordinance, unless the context otherwise requires -

(a) 'Self Help Group (SHG)' means a group of women formed on principles of self help and registered as such with the Society for Elimination of Rural Poverty (SERP) in the rural areas or Mission for Elimination of Urban Poverty in Municipal areas (MEPMA) in urban areas.

(b) 'Society for Elimination of Rural Poverty (SERP)' is a Society formed by Government for the purpose of implementing pro-poor initiatives and thereby eliminating poverty in rural areas.

(c) Society under 'Mission for eliminating poverty in municipal areas (MEPMA)' is a Society formed by Government for the purpose of implementing pro-poor initiatives and thereby eliminating poverty in urban areas.

(d) 'Micro finance institution (MFI)' means any person, partnership Firm, group of persons, including a Company registered under the provisions of the Companies Act 1956, a Non-Banking Finance Company as defined under section 58-A of the Reserve Bank of India Act 1934, a Society registered under the A.P. Cooperative Societies Act 1964, or the A.P. Societies Registration Act 2001 and the like, in whichever manner formed and by whatever name called, whose principal or incidental activity is to lend money or offer financial support of whatsoever nature to the low income population.

(e) 'Government' means the State Government of Andhra Pradesh.

(f) 'SHG bank linkage' means provision of credit for the SHGs by the commercial banks based on a micro credit plan prepared by the SHGs for carrying out economic activities.

(g) 'Interest' for the purposes of the terms defined under the provisions of this Ordinance would mean a return on the amount lent by the MFI to a SHG.

(g) 'Loan' means an advance whether of money or in kind given to the borrowing SHG at interest, whether given before the commencement of this Act or after such commencement and

includes advance, discount, money paid for or on account of or paid on behalf of or at the request of any person, or any account whatsoever, and every agreement (whatever its terms or form may be) which is in substance or effect a loan of money or in kind given to an SHG and further includes, an agreement relating to the repayment of any such loan.

(i) 'Notification' means a notification published in the Andhra Pradesh Gazette and the word 'notified' shall be construed accordingly.

(j) 'Prescribed' means prescribed by Rules made under this Ordinance.

(k) 'Registering Authority' means the Project Director District Rural Development Agency for the rural areas and Project Director MEPMA for urban areas; or any other person appointed by the District Collector to perform the functions of a registering authority under this Ordinance for such District.

(l) 'Registration' means registration granted to a MFI under this Ordinance.

(m) "SHG Member" means a registered member of a SHG who intends to avail a loan through such SHG.

(n) Words used but not defined in this Ordinance, shall have the same meaning assigned under the relevant Acts.

Registration of MFIs

3. (1) All MFIs operating in the State of Andhra Pradesh as on the date of the commencement of this Ordinance, shall within thirty days from the date of commencement of this Ordinance, apply for Registration before the Registering Authority of the district specifying therein the villages or towns in which they have been operating or propose to operate, the rate of interest being charged or proposed to be charged, system of conducting due diligence and system of effecting recovery and list of persons authorized for conducting the activity of lending or recovery of money which has been lent.

(2) No MFIs, operating at the commencement of this Ordinance or intending to start the business of lending money to SHGs, after the commencement of this Ordinance, shall grant any loans or recover any loans without obtaining registration under this Ordinance from the Registering Authority.

(3) The Registering Authority shall conduct verification of the details furnished by the MFI and accord registration in such manner as may be prescribed for operation of MFIs for a period of one year, after obtaining a written undertaking from the MFI that it shall always act in conformity with the provisions of this Ordinance.

(4) Where the MFI applies for renewal of registration, an application for that purpose shall be filed by the MFI 60 days before the expiry of the period of one year referred to in sub-section (3) and the Registering Authority shall decide either to grant renewal or refuse renewal of registration within 15 days before the date of expiry of registration, after due verification of the performance of the MFIs in the field level and after hearing objections, if any, from the general public regarding extension of Registration.

Register of MFIs

4. (1) Every registering authority shall maintain for the area under its jurisdiction registers of all MFIs having valid registration in such form as may be prescribed.

(2) The registers maintained under sub-section (1) shall be published in such manner and at such intervals as may be prescribed.

MFIs to obtain registration

5. (1) The Registering Authority may, at any time, either suo-moto or upon receipt of complaints by SHGs or its members or by members of the public cancel the registration of an MFI after assigning sufficient reasons for such cancellation.

Provided that no order of cancellation of the Registration shall be passed without issuing notice to the MFI intimating the facts upon which the prima-facie decision to cancel the registration has been taken and the MFI shall be afforded a reasonable opportunity to show cause against such notice.

Explanation: For the purposes of sub-section (1), conviction of a MFI for an offence of violation of any of the provisions of this Ordinance shall be sufficient cause for suspension or cancellation of its registration.

(2) Pending enquiry under sub-section (1), the Registering Authority may, for sufficient reasons to be recorded, suspend the Registration of an MFI.

Member of SHG not to be member of more than one SHG

6. No member of an SHG shall be a member of more than one SHG, provided that where a member has, at the commencement of this Ordinance, become a member of more than one SHG, she shall have the option to retain the membership of one SHG and to terminate her membership in other SHGs and for that purpose, she shall issue a notice to such SHGs about her option to terminate her membership, settle and pay the amount payable to the MFIs which had lent monies to such SHGs, within a period of 3 months from the date of commencement of this Ordinance.

MFIs not to seek security for loan

7. No MFI shall seek any security from a borrower by way of pawn, pledge or other security for the loan.

Provided that any such security obtained from a borrower before the commencement of this Ordinance shall forthwith stand released in favour of the borrower.

Display of rates of interest charged by MFIs

8. (1) All MFIs shall display the rates of interest charged by them in a conspicuous place in their premises in bold letters visible to the members of the public.

(2) No MFI shall charge any other amount from the borrower except any charge prescribed in the Rules for submission of an application for grant of a loan.

Maximum amount of interest recoverable on loans and discharge of loans in certain cases

9. (1) No MFI shall recover from the borrower towards interest in respect of any loans advanced by it, whether before or after commencement of this Ordinance, an amount in excess of the principal amount.

(2) All loans in respect of which an MFI has realized from the borrower, whether before or after commencement of this Ordinance, an amount equal to twice the amount of the principal, shall stand discharged and the borrower shall be entitled to obtain refund and the MFI shall be bound to refund the excess amount paid by the borrower.

Prior approval for grant of further loans to SHGs or their members

10. (1) No MFI shall extend a further loan to a SHG or its members, where the SHG has an outstanding loan from a Bank unless the MFI obtains the prior approval in writing in such manner as may be prescribed from the Registering Authority after making an application seeking such approval.

(2) The Registering Authority while considering such application from an MFI seeking approval as aforesaid, shall secure the following information in writing from the MFI in regard to every member of SHG namely,

- i) Name of the Borrower
- ii) name of the SHG
- iii) bank from which loan has been obtained by the SHG
- iv) date of the loan granted by the bank
- v) amount paid to the SHG by the bank
- vi) amount due from the SHG
- vii) fresh amount of loan sought by the SHG from the MFI
- viii) terms of repayment proposed by the MFI
- ix) details of due diligence including the capacity of the SHG for repayment and
- x) such other details as may be prescribed by Rules made under this Ordinance.

(3) The Registering Authority shall, not later than fifteen days from the date of filing of such application for approval under subsection (2), cause an enquiry into the contents of the application and shall grant approval for further loan unless the Registering Authority is satisfied that the SHG and its members have passed a resolution that they have understood the conditions of the loan and terms of repayment and unless the Registering Authority is also satisfied that such further loan would generate additional income to the SHG and its members, needed for servicing the debt.

(4) No MFI shall grant loan to a member of SHG during the subsistence of two previous loans irrespective of the source of the previous two loans.

Duty of MFIs to maintain accounts and furnish copies

11. (1) All borrowings by a member of an SHG from an MFI shall be contracted in the manner, form and format prescribed under the Ordinance.

(2) Every MFI shall keep and maintain a cash book, a ledger and such other books of account in such form and in such manner as may be prescribed.

(3) Every MFI shall -

(a) Deliver or cause to be delivered, to the borrower within seven days from the date on which a loan is made, a statement in the prescribed form showing in clear and distinct terms the amount and date of the loan and of its maturity, the name and address of the functionary of the MFI and the effective rate of interest charged.

(b) Upon repayment of a loan in full, the MFI shall obtain an indelible mark on every paper signed by the borrower with words indicating such repayment and provide copies thereof to the borrower.

(4) No MFI shall receive any payment from a borrower on account of any loan without giving him a duly signed receipt for the payment.

(5) An MFI shall, on a demand in writing by the borrower, supply a copy of any document relating to a loan obtained by him, or if the borrower so requires, to any person specified in that behalf in the demand.

Provided that in respect of loans given prior to the commencement of this Ordinance, it shall be obligatory for the lender to specify if any security was accepted from the borrower.

(6) All tranches of repayment shall be made by the group at the office of the Gram Panchayat only.

(7) MFI shall not deploy any agents for recovery nor shall use any other coercive action either by itself or by its agents for recovery of money from the borrower; and any form of coercive recovery including but not limited to visiting the house of the borrower shall, apart being punishable under the provisions of the Ordinance, empower the Registering Authority to suspend or cancel the license of such an MFI as provided in Section 5.

Submissions of monthly statements by MFIs

12. Every MFI shall submit a Monthly Statement to the Registering Authority before 10th day of every month giving therein the list of borrowers, the loan given to each and the interest rate charged on the repayment made.

Power to require production of records or documents and power of entry, inspection and seizure

13. (1) The Registering Authority or any officer authorised by him in this behalf may, to verify whether the business of the MFI is being carried on in accordance with the provisions of this Ordinance, enter the premises of the MFI office or of any person who in his opinion is carrying on the business of lending and call upon him to produce any record or document relating to such business and every such MFI shall allow such inspection and produce such record or document.

(2) The Registering Authority may, for the purposes of sub-section (1), search the premises and seize any record and document as may be necessary and the record or document seized shall be retained only for such period as may be necessary for the purposes of examination, prosecution or other legal action.

Provided that the provisions of Sections 100 and 102 of the Code of Criminal Procedure, 1973 shall, so far as may be, apply to such search and seizure.

(3) The registering authority or the other officer referred to in subsection (1) shall also have power to summon and examine the MFI or any person who in his opinion is in a position to furnish relevant information.

Complaints

14. Any SHG or its members or any member of the public can file a complaint regarding violation of the provision of this Ordinance by a MFI before the Registering Authority and the said Authority shall enquire into the same after giving a reasonable opportunity to the MFI to show cause and pass such orders as it may deem fit including an order under section 5 of the Ordinance.

Settlement of Disputes

15. (1) For the protection of debtors and for the settlement of disputes of civil nature between the SHG or its members on the one hand and the MFI on the other hand or between the members of the

SHG and the SHG, in relation to the loans granted under this Ordinance to the SHG or its members, the State Government after consultation with the High Court, and by notification, -

(a) Shall, as soon as may be after the commencement of this Ordinance, establish for every district in the State a Fast-Track Court;

(b) May establish Fast-Track Court for such other areas in the State, as it may deem necessary.

(2) The Government shall, after consultation with the High Court of Andhra Pradesh specify, by notification, the local limits of the area to which the jurisdiction of a Fast-Track Court shall extend and may, at any time, increase, reduce or alter such limits.

3) The cases that may be filed before the fast-Track Court shall be disposed of within a period of three months.

(4) The decree of the Fast Track Courts shall be liable to be executed in accordance with the procedure under the Code of the Civil Procedure 1908.

Penalty for coercive actions MFIs

16. (1) All persons who are connected with and responsible for the day-to-day control, business and management of a MFI including the Partners, Directors and the employees who resort to any type of coercive measures against the SHGs or its members of their family members shall be liable for punishment of imprisonment which may extend up to a period of three years or with fine which may extend to one lakh rupees or with both.

Explanation:- For the purposes of this section, “coercive action” by an MFI against the SHGs or its members of their family members include the following -

(a) obstructing or using violence to, insulting or intimidating the borrower or his family members, or

(b) persistently following the borrower or his family member from place to place or interfering with any property owned or used by him or depriving him of, or hindering him in, the use of any such property

(c) frequenting the house or other place where such other person resides or works, or carries on business, or happens to be, or

(d) doing any act calculated to annoy or intimidate such person or the members of his family, or

(e) moving or acting in a manner which causes or is calculated to cause alarm or danger to the person or property of such other person

(f) seeking to remove forcibly any document from the borrower which entitles the borrower to a benefit under any Government programme.

Provided that a person who frequents the house or place referred to in clause (c) in order merely to obtain or communicate information shall not be deemed to be using coercive action.

(2) The MFI or the persons who use coercive actions as stated in sub section (1) shall be prosecuted in accordance with the provisions of this Ordinance.

(3) The provisions of the Code of Criminal Procedure, 1973, shall, so far as may be, apply to the proceedings before a Fast Track Court, and for the purpose of the said provisions, a Fast Track Court shall be deemed to be a Magistrate.

Penalty for carrying on Business without registration

17. All persons who are connected with and responsible for the day-to-day control, business and management of a MFI including the Partners and Directors of such MFI which carries on the business of providing loans either without obtaining registration of the MFI from the Registering Authority under Section 3 of the Ordinance, shall be liable for punishment with imprisonment for a term which may extend to three years and with fine which may extend to rupees one lakh.

Penalty for contravention of the provisions of the Ordinance

18. If any person contravenes any provision other than Section 3 of this Ordinance, he shall be punishable with imprisonment for a period of six months or with fine which may extend to ten thousand rupees or with both.

Every officer to be public servant

19. Every officer of the Government and every person acting under the provisions of this Ordinance shall be deemed to be a public servant within the meaning of section 21 of the Indian Penal Code.

Bar of certain proceedings.

20. (1) No suit, prosecution or other proceedings shall lie against any officer or employee of the Government for any act done or purporting to be done under this Ordinance, without the previous sanction of the Government.

(2) No suit, prosecution or other legal proceedings shall be instituted against any person for anything which is, in good faith, done or intended to be done under this Ordinance or the rules made thereunder.

Power to remove difficulties.

21. If any difficulty arises in giving effect to the provisions of this Ordinance, the Government may, by notification, remove difficulties by orders not inconsistent with the provisions of this Ordinance, but which appear to them to be necessary or expedient to remove such difficulty.

Power to give directions

22. The Government may, from time to time, issue such orders, instructions and directions not inconsistent with the provisions of this Ordinance and the rules made thereunder to the officers for the proper administration of the Ordinance, and such officers and all other persons employed in the enforcement of the Ordinance, shall comply with such orders, instructions and directions.

Power to make rules

23. (1) The State Government may, by notification, make rules for carrying out the purposes of this Ordinance.

(2) Every rule made under this Ordinance shall, immediately after it is made, be laid before the Legislature of the State, if it is in session and if it is not in session, in the session immediately following for a total period of fourteen days which may be comprised in one session or in two successive sessions and if, before the expiration of the session in which it is so laid or the session immediately following the Legislature agrees in making any modification in the rule or in the annulment of the rule, the rule shall, from the date on which the modification or annulment is notified, have effect only in such modified form or shall stand annulled as the case may be so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that rule.

Annual Report on The administration of the Ordinance

24. The Government shall prepare an annual report on the administration of this Ordinance and the same shall be placed before the State Legislature.

STATEMENT OF OBJECTS AND REASONS

The Government of Andhra Pradesh has made rapid strides in the field of financial inclusion of the rural & urban poor by organising women self help groups (SHGs); and linking them with the banks for meeting their credit needs.

Of late, many individuals and entities have come up styling themselves as Micro Finance Institutions and are giving loans to SHGs at very high or usurious rates of interest and are using inhuman coercive methods for recovery of the loans.

This has even resulted in suicides by many rural poor who have obtained loans from such individuals or entities.

In the larger public interest and to protect the poor from exploitation, and to regulate the lending of monies to the SHGs by the MFIs, the Government intends to bring into force a law containing the various provisions stated in this Bill in order to check the illegal acts of these MFIs.

This Bill seeks to give effect to the above decision.

ACTS OF THE RBI

REPORT OF THE SUB-COMMITTEE OF THE CENTRAL BOARD OF DIRECTORS OF RESERVE BANK OF INDIA TO STUDY ISSUES AND CONCERNS IN THE MFI SECTOR (MALEGAM RECOMMENDATIONS) – RBI, JANUARY 2011

SUMMARY OF RECOMMENDATIONS (ANNEXURE TO THE REPORT)

Para 3.8. - The need for regulation

A separate category be created for NBFCs operating in the Microfinance sector, such NBFCs being designated as NBFC-MFI

Para 4.2. Definition

A NBFC-MFI may be defined as

“A company (other than a company licensed under Section 25 of the Companies Act, 1956) which provides financial services pre-dominantly to low-income borrowers with loans of small amounts, for short-terms, on unsecured basis, mainly for income-generating activities, with repayment schedules which are more frequent than those normally stipulated by commercial banks and which further conforms to the regulations specified in that behalf”.

Provision should be made in the regulations to further define each component of this definition.

Para 5.9. Regulations to be specified

A NBFC classified as a NBFC-MFI should satisfy the following conditions:

a) Not less than 90% of its total assets (other than cash and bank balances and money market instruments) are in the nature of “qualifying assets.”

b) For the purpose of (a) above, a “qualifying asset” shall mean a loan which satisfies the following criteria:-

- i. the loan is given to a borrower who is a member of a household whose annual income does not exceed Rs. 50,000;
- ii. the amount of the loan does not exceed Rs. 25,000 and the total outstanding indebtedness of the borrower including this loan also does not exceed Rs. 25,000;
- iii. the tenure of the loan is not less than 12 months where the loan amount does not exceed Rs. 15,000 and 24 months in other cases with a right to the borrower of prepayment without penalty in all cases;
- iv. the loan is without collateral;
- v. the aggregate amount of loans given for income generation purposes is not less than 75% of the total loans given by the MFIs;
- vi. the loan is repayable by weekly, fortnightly or monthly installments at the choice of the borrower.

c) The income it derives from other services is in accordance with the regulation specified in that behalf.

Para 5.10. - Regulations to be specified

A NBFC which does not qualify as a NBFC-MFI should not be permitted to give loans to the microfinance sector, which in the aggregate exceed 10% of its total assets.

Para 7.11. - Pricing of Interest

There should be a “margin cap” of 10% in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of Rs. 100 crores and a “margin cap” of 12% in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of an amount not exceeding Rs. 100 crores. There should also be a cap of 24% on individual loans.

Para 8.7. - Transparency in Interest Charges

a) There should be only three components in the pricing of the loan, namely (i) a processing fee, not exceeding 1% of the gross loan amount (ii) the interest charge and (iii) the insurance premium.

b) Only the actual cost of insurance should be recovered and no administrative charges should be levied.

c) Every MFI should provide to the borrower a loan card which (i) shows the effective rate of interest (ii) the other terms and conditions attached to the loan (iii) information which adequately identifies the borrower and (iv) acknowledgements by the MFI of payments of installments received and the final discharge. The Card should show this information in the local language understood by the borrower.

d) The effective rate of interest charged by the MFI should be prominently displayed in all its offices and in the literature issued by it and on its website.

e) There should be adequate regulations regarding the manner in which insurance premium is computed and collected and policy proceeds disposed off.

f) There should not be any recovery of security deposit. Security deposits already collected should be returned.

g) There should be a standard form of loan agreement.

Para 9.7. - Multiple-lending, Over-borrowing and Ghost-borrowers

a) MFIs should lend to an individual borrower only as a member of a JLG and should have the responsibility of ensuring that the borrower is not a member of another JLG.

b) a borrower cannot be a member of more than one SHG/JLG.

c) not more than two MFIs should lend to the same borrower.

d) there must be a minimum period of moratorium between the grant of the loan and the commencement of its repayment.

e) recovery of loan given in violation of the regulations should be deferred till all prior existing loans are fully repaid.

Para 9.12. - Multiple-lending, Over-borrowing and Ghost-borrowers

All sanctioning and disbursement of loans should be done only at a central location and more than one individual should be involved in this function. In addition, there should be close supervision of the disbursement function.

Para 10.5. - Credit Information Bureau

a) One or more Credit Information Bureaus should be established and be operational as soon as possible and all MFIs be required to become members of such bureau.

b) In the meantime, the responsibility to obtain information from potential borrowers regarding existing borrowings should be on the MFI.

Para 11.12. - Coercive Methods of Recovery

a) The responsibility to ensure that coercive methods of recovery are not used should rest with the MFIs and they and their managements should be subject to severe penalties if such methods are used.

b) The regulator should monitor whether MFIs have a proper Code of Conduct and proper systems for recruitment, training and supervision of field staff to ensure the prevention of coercive methods of recovery.

c) Field staff should not be allowed to make recovery at the place of residence or work of the borrower and all individual loans.

Para 15.3 - Corporate Size

All NBFC-MFIs should have a minimum Net Worth of Rs.15 crores

Para 16.3. - Corporate Governance

Every MFI should be required to have a system of Corporate Governance in accordance with rules to be specified by the Regulator

Para 17.3. - Maintenance of Solvency

Provisioning for loans should not be maintained for individual loans but an MFI should be required to maintain at all times an aggregate provision for loan losses which shall be the higher of:

1% of the outstanding loan portfolio or (ii) 50% of the aggregate loan installments which are overdue for more than 90 days and less than 180 days and 100% of the aggregate loan installments which are

overdue for 180 days or more.

Para 17.5. - Maintenance of Solvency

NBFC-MFIs should be required to maintain Capital Adequacy Ratio of 15% and subject to recommendation 21 below, all of the Net Owned Funds should be in the form of Tier I Capital.

Para 18.10.- Need for Competition

Bank lending to the Microfinance sector both through the SHG-Bank Linkage programme and directly should be significantly increased and this should result in a reduction in the lending interest rates.

Para 19.5. – Priority Sector Status

Bank advances to MFIs shall continue to enjoy “priority sector lending” status. However, advances to MFIs which do not comply with the regulation should be denied “priority sector lending” status. It may also be necessary for the Reserve Bank to revisit its existing guidelines for lending to the priority sector in the context of the Committee’s recommendations.

Para 20.5. - Assignment and Securitisation

a) Disclosure is made in the financial statements of MFIs of the outstanding loan portfolio which has been assigned or securitised and the MFI continues as an agent for collection. The amounts assigned and securitised must be shown separately.

b) Where the assignment or securitisation is with recourse, the full value of the outstanding loan portfolio assigned or securitised should be considered as risk-based assets for calculation of Capital Adequacy.

c) Where the assignment or securitisation is without recourse but credit enhancement has been given, the value of the credit enhancement should be deducted from the Net Owned Funds for the purpose of calculation of Capital Adequacy.

d) Before acquiring assigned or securitised loans, banks should ensure that the loans have been made in accordance with the terms of the specified regulations.

Para 21.4. - Assignment and Securitisation

a) Disclosure is made in the financial statements of MFIs of the outstanding loan portfolio which has been assigned or securitised and the MFI continues as an agent for collection. The amounts assigned and securitised must be shown separately.

b) Where the assignment or securitisation is with recourse, the full value of the outstanding loan portfolio assigned or securitised should be considered as risk-based assets for calculation of Capital Adequacy.

c) Where the assignment or securitisation is without recourse but credit enhancement has been given, the value of the credit enhancement should be deducted from the Net Owned Funds for the purpose of calculation of Capital Adequacy.

d) Before acquiring assigned or securitised loans, banks should ensure that the loans have been made in accordance with the terms of the specified regulations.

Para 22.7. - Monitoring of Compliance

a) The primary responsibility for ensuring compliance with the regulations should rest with the MFI itself and it and its management must be penalized in the event of non-compliance

b) Industry associations must ensure compliance through the implementation of the Code of Conduct with penalties for non-compliance.

c) Banks also must play a part in compliance by surveillance of MFIs through their branches.

d) The Reserve Bank should have the responsibility for off-site and on-site supervision of MFIs but the on-site supervision may be confined to the larger MFIs and be restricted to the functioning of the organizational arrangements and systems with some supervision of branches. It should also include supervision of the industry associations in so far as their compliance mechanism is concerned. Reserve Bank should also explore the use of outside agencies for inspection.

e) The Reserve Bank should have the power to remove from office the CEO and / or a director in the event of persistent violation of the regulations quite apart from the power to deregister an MFI and prevent it from operating in the microfinance sector.

f) The Reserve Bank should considerably enhance its existing supervisory organisation dealing with NBFC-MFIs.

Para 23.4. - Moneylenders Acts

NBFC-MFIs should be exempted from the provisions of the Money-Lending Acts, especially as we are recommending interest margin caps and increased regulation.

Para 24.7. - The Micro Finance (Development and Regulation) Bill 2010

Subject to Smt.Rajagopalan's reservations as expressed in para. 24.6 above, we would, therefore, recommend the following:

a) The proposed Act should provide for all entities covered by the Act to be registered with the Regulator. However, entities where aggregate loan portfolio (including the portfolio of associated entities) does not exceed Rs. 10 crores may be exempted from registration.

b) If NABARD is designated as the regulator under the proposed Act, there must be close co-ordination between NABARD and Reserve Bank in the formulation of the regulations applicable to the regulated entities.

c) The micro finance entities governed by the proposed Act should not be allowed to do the business of providing thrift services.

Para 25.7. - The Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act

If the Committee's recommendations are accepted, the need for a separate Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act will not survive.

Para 26.2. - Transitory Provisions

(a) 1st April 2011 may be considered as a cut- off date by which time our recommendations, if accepted, must be implemented. In particular, the recommendations as to the rate of interest must, in any case, be made effective to all loans given by an MFI after 31st March 2011.

(b) As regards other arrangements, Reserve Bank may grant such extension of time as it considers appropriate in the circumstances. In particular, this extension may become necessary for entities which currently have activities other than microfinance lending and which may need to form separate entities confined to microfinance activities.

SELECTED PROVISIONS OF THE REPORT

1 Introduction

1.1 The Board of Directors of the Reserve Bank of India, at its meeting held on October 15, 2010 formed a Sub-Committee of the Board to study issues and concerns in the microfinance sector in so far as they related to the entities regulated by the Bank.

1.2 The composition of the Sub-Committee was as under:-

Shri Y.H. Malegam – Chairman

Shri Kumar Mangalam Birla

Dr. K. C. Chakrabarty

Smt. Shashi Rajagopalan

Prof. U.R. Rao

Shri V. K. Sharma (Executive Director) – Member Secretary

1.3 The terms of reference of the Sub-Committee were as under:-

1. To review the definition of 'microfinance' and 'Micro Finance Institutions (MFIs)' for the purpose of regulation of non-banking finance companies (NBFCs) undertaking microfinance by the Reserve Bank of India and make appropriate recommendations.
2. To examine the prevalent practices of MFIs in regard to interest rates, lending and recovery practices to identify trends that impinge on borrowers' interests.
3. 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.
4. To examine and make appropriate recommendations in regard to applicability of money lending legislation of the States and other relevant laws to NBFCs/MFIs.

5. To examine the role that associations and bodies of MFIs could play in enhancing transparency disclosure and best practices
6. To recommend a grievance redressal machinery that could be put in place for ensuring adherence to the regulations recommended at 3 above.
7. To examine the conditions under which loans to MFIs can be classified as priority sector lending and make appropriate recommendations. 2
8. To consider any other item that is relevant to the terms of reference.

2 The Microfinance sector

2.1 Microfinance is an economic development tool whose objective is to assist the poor to work their way out of poverty. It covers a range of services which include, in addition to the provision of credit, many other services such as savings, insurance, money transfers, counseling, etc.

2.2 For the purposes of this report, the Sub-Committee has confined itself to only one aspect of Microfinance, namely, the provision of credit to low-income groups.

2.3 The provision of credit to the Microfinance sector is based on the following postulates:

- a) It addresses the concerns of poverty alleviation by enabling the poor to work their way out of poverty.
- b) It provides credit to that section of society that is unable to obtain credit at reasonable rates from traditional sources.
- c) It enables women's empowerment by routing credit directly to women, thereby enhancing their status within their families, the community and society at large.
- d) Easy access to credit is more important for the poor than cheaper credit which might involve lengthy bureaucratic procedures and delays.
- e) The poor are often not in a position to offer collateral to secure the credit.
- f) Given the imperfect market in which the sector operates and the small size of individual loans, high transaction costs are unavoidable. However, when communities set up their own institutions, such as SHG federations and co-operatives the transaction costs are lower.
- g) Transaction costs, can be reduced through economies of scale. However, increases in scale cannot be achieved, both for individual operations and for the sector as a whole in the absence of cost recovery and profit incentive. 3

2.4 Given the above considerations, the essential features of credit for Microfinance which have evolved are as under:-

- a) The borrowers are low-income groups.
- b) The loans are for small amounts.
- c) The loans are without collateral.
- d) The loans are generally taken for income-generating activities, although loans are also provided for consumption, housing and other purposes.
- e) The tenure of the loans is short.
- f) The frequency of repayments is greater than for traditional commercial loans.

2.5 The players in the Microfinance sector can be classified as falling into three main groups

- a) The SHG-Bank linkage Model accounting for about 58% of the outstanding loan portfolio
- b) Non-Banking Finance Companies accounting for about 34% of the outstanding loan portfolio
- c) Others including trusts, societies, etc, accounting for the balance 8% of the outstanding loan portfolio. Primary Agricultural Co-operative Societies numbering 95,663, covering every village in the country, with a combined membership of over 13 crores and loans outstanding of over Rs.64, 044 crores as on 31.03.09 have a much longer history and are under a different regulatory framework. Thrift and credit co-operatives are scattered across the country and there is no centralized information available about them.

2.6 The SHG-Bank Linkage Model was pioneered by NABARD in 1992. Under this model, women in a village are encouraged to form a Self help Group (SHG) and members of the Group regularly contribute small savings to the Group. These savings which form an ever growing nucleus are lent by the group to members, and are later supplemented by loans provided by banks for income-generating activities and other purposes for sustainable livelihood

promotion. The Group has weekly/monthly meetings at which new savings come in, and recoveries are made from members towards their loans from the SHGs, their federations, and banks. NABARD provides grants, training and capacity building assistance to Self Help Promoting Institutions (SHPI), which in turn act as facilitators/ intermediaries for the formation and credit linkage of the SHGs.

- 2.7 Under the NBFC model, NBFCs encourage villagers to form Joint Liability Groups (JLG) and give loans to the individual members of the JLG. The individual loans are jointly and severally guaranteed by the other members of the Group. Many of the NBFCs operating this model started off as non-profit entities providing micro-credit and other services to the poor. However, as they found themselves unable to raise adequate resources for a rapid growth of the activity, they converted themselves into for-profit NBFCs. Others entered the field directly as for-profit NBFCs seeing this as a viable business proposition. Significant amounts of private equity funds have consequently been attracted to this sector.

3 The need for regulation

- 3.1 All NBFCs are currently regulated by Reserve Bank under Chapters III-B, III-C and V of the Reserve Bank of India Act. There is, however, no separate category created for NBFCs operating in the Microfinance sector.

- 3.2 The need for a separate category of NBFCs operating in the Microfinance sector arises for a number of reasons.

- 3.3 First, the borrowers in the Microfinance sector represent a particularly vulnerable section of society. They lack individual bargaining power, have inadequate financial literacy and live in an environment which is fragile and exposed to external shocks which they are ill-equipped to absorb. They can, therefore, be easily exploited.

- 3.4 Second, NBFCs operating in the Microfinance sector not only compete amongst themselves but also directly compete with the SHG-Bank Linkage Programme. The practices they adopt could have an adverse impact on the programme. In a representation made to the Sub-Committee by the Government of Andhra Pradesh, it has been argued, that the MFIs are riding “piggy-back” on the SHG infrastructure created by the programme and that JLGs are being formed by poaching members from existing SHGs. About 30% of MFI loans are purportedly in Andhra Pradesh. The Microfinance in India- A State of Sector Report 2010 also says that there are many reports of SHGs splitting and becoming JLGs to avail of loans from MFIs. The A.P. Government has also stated that as the loans given by MFIs are of shorter duration than the loans given under the programme, recoveries by SHGs are adversely affected and loans given by the SHGs are being used to repay loans given by MFIs. While we did not, as committee, examine each of these issues in depth, the fact that these complaints have been made reinforces the need for a separate and focused regulation.

- 3.5 Thirdly, credit to the Microfinance sector is an important plank in the scheme for financial inclusion. A fair and adequate regulation of NBFCs will encourage the growth of this sector while adequately protecting the interests of the borrowers.

- 3.6 Fourth, over 75% of the finance obtained by NBFCs operating in this sector is provided by banks and financial institutions including SIDBI. As at 31st March 2010, the aggregate amount outstanding in respect of loans granted by banks and SIDBI to NBFCs operating in the Microfinance sector amounted to Rs.13,800 crores. In addition, banks were holding securitized paper issued by NBFCs for an amount of Rs.4200 crores. Banks and Financial Institutions including SBIDBI also had made investments in the equity of such NBFCs. Though this exposure may not be significant in the context of the total assets of the banking system, it is increasing rapidly.

- 3.7 Finally, given the need to encourage the growth of the Microfinance sector and the vulnerable nature of the borrowers in the sector, there may be a need to give special facilities or dispensation to NBFCs operating in this sector, alongside an appropriate regulatory framework. This will be facilitated if a separate category of NBFCs is created for this purpose.

- 3.8 We would therefore recommend that a separate category be created for NBFCs operating in the Microfinance sector, such NBFCs being designated as NBFC-MFI.

4 Definition

4.1 Once a separate category of NBFC-MFI is created, it becomes necessary to provide in the regulations a definition for such NBFCs. This definition must incorporate the distinctive features of a NBFC-MFI.

4.2 The Sub-Committee therefore recommends that a NBFC-MFI may be defined as

“A company (other than a company licensed under Section 25 of the Companies Act, 1956) which provides financial services pre-dominantly to low-income borrowers with loans of small amounts, for short-terms, on unsecured basis, mainly for income-generating activities, with repayment schedules which are more frequent than those normally stipulated by commercial banks and which further conforms to the regulations specified in that behalf”.

5. Regulations to be specified

5.9. We would, therefore, recommend that a NBFC classified as a NBFC-MFI should satisfy the following conditions:

- a) Not less than 90% of its total assets (other than cash and bank balances and money market instruments) are in the nature of “qualifying assets.”
- b) For the purpose of (a) above, a “qualifying asset” shall mean a loan which satisfies the following criteria:-
 - i. the loan is given to a borrower who is a member of a household whose annual income does not exceed Rs. 50,000;
 - ii. the amount of the loan does not exceed Rs. 25,000 and the total outstanding indebtedness of the borrower including this loan also does not exceed Rs. 25,000;
 - iii. the tenure of the loan is not less than 12 months where the loan amount does not exceed Rs. 15,000 and 24 months in other cases with a right to the borrower of prepayment without penalty in all cases;
 - iv. the loan is without collateral;
 - v. the aggregate amount of loans given for income generation purposes is not less than 75% of the total loans given by the MFIs;
 - vi. the loan is repayable by weekly, fortnightly or monthly installments at the choice of the borrower.
- c) The income it derives from other services is in accordance with the regulation specified in that behalf.

5.10 We would also recommend that a NBFC which does not qualify as a NBFC-MFI should not be permitted to give loans to the microfinance sector, which in the aggregate exceed 10% of its total assets.

8. Transparency in Interest Charges

8.7 We would, therefore, recommend that:-

- a) There should be only three components in the pricing of the loan, namely (i) a processing fee, not exceeding 1% of the gross loan amount (ii) the interest charge and (iii) the insurance premium.
- b) Only the actual cost of insurance should be recovered and no administrative charges should be levied.
- c) Every MFI should provide to the borrower a loan card which (i) shows the effective rate of interest (ii) the other terms and conditions attached to the loan (iii) information which adequately identifies the borrower and (iv) acknowledgements by the MFI of payments of installments received and the final discharge. The Card should show this information in the local language understood by the borrower.
- d) The effective rate of interest charged by the MFI should be prominently displayed in all its offices and in the literature issued by it and on its website.
- e) There should be adequate regulations regarding the manner in which insurance premium is computed and collected and policy proceeds disposed off.
- f) There should not be any recovery of security deposit. Security deposits already collected should be returned.

g) There should be a standard form of loan agreement.

9. Multiple-lending, Over-Borrowing and Ghost-Borrowing

9.7 We would, therefore, recommend that:-

- a) MFIs should lend to an individual borrower only as a member of a JLG and should have the responsibility of ensuring that the borrower is not a member of another JLG.
- b) a borrower cannot be a member of more than one SHG/JLG.
- c) not more than two MFIs should lend to the same borrower.
- d) there must be a minimum period of moratorium between the grant of the loan and the commencement of its repayment.
- e) recovery of loan given in violation of the regulations should be deferred till all prior existing loans are fully repaid.

10. Credit Information Bureau

10.5 We would therefore recommend that

- a) One or more Credit Information Bureaus be established and be operational as soon as possible and all MFIs be required to become members of such bureau.
- b) In the meantime, the responsibility to obtain information from potential borrowers regarding existing borrowings should be on the MFI.

11. Coercive Methods of Recovery

11.9 A key component in the prevention of coercive recovery is an adequate grievance redressal procedure. It is necessary that there should be a grievance redressal system established by each MFI and for this to be made known to the borrower in the literature issued, by display in its offices, by posting on the website and by prominent inclusion in the Loan Card given to the borrower. In addition, it is necessary that there should be independent authorities established to whom the borrower can make reference.

21. Funding of MFIs

21.4 We would, therefore, recommend that:

- a) The creation of one or more "Domestic Social Capital Funds" may be examined in consultation with SEBI.
- b) MFIs should be encouraged to issue preference capital with a ceiling on the coupon rate and this can be treated as part of Tier II capital subject to capital adequacy norms.

RESERVE BANK OF INDIA - MONETARY POLICY STATEMENT 2011-12

(SELECTED PROVISIONS)

IV Credit Delivery and Financial Inclusion

Credit Flow to the Micro, Small and Medium Enterprises Sector

High Level Task Force on MSMEs

88. As indicated in the Second Quarter Review of November 2010, the Reserve Bank, based on the recommendations of the High Level Task Force on Micro, Small and Medium Enterprises (MSMEs), issued guidelines in June 2010, advising scheduled commercial banks that the allocation of 60 per cent of micro and small enterprises (MSEs) advances to the micro enterprises was to be achieved in stages, viz., 50 per cent in the year 2010-11, 55 per cent in the year 2011-12 and 60 per cent in the year 2012-13. Further, banks were mandated to achieve a 10 per cent annual growth in the number of micro enterprise accounts and a 20 per cent year-on-year growth in credit to the MSE sector. The Reserve Bank is closely monitoring the achievement of targets by banks on a half-yearly basis, i.e., March and September each year. A suitable format has been devised by the Reserve Bank to capture and monitor the achievement of the targets by banks and the same are regularly reviewed at

the highest level. Banks, which lag behind in achieving the targets, have been mandated to submit an action plan to achieve the prescribed targets.

Rural Credit Institutions

Licensing of Co-operatives

89. In terms of the recommendations of the Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla) and as proposed in the Annual Policy Statement of April 2009, the work relating to licensing of unlicensed state and central co-operative banks in a non-disruptive manner, in consultation with National Bank for Agriculture and Rural Development (NABARD), was initiated. Subsequent to the issuance of revised guidelines on licensing of state co-operative banks (StCBs)/district central co-operative banks (DCCBs), 10 StCBs and 144 DCCBs were licensed, bringing down the number of unlicensed StCBs from 17 to 7 and unlicensed DCCBs from 296 to 152 as on March 31, 2011.

Revival of the Rural Co-operative Credit Structure

90. The Government of India, based on the recommendations of the Task Force on Revival of Rural Co-operative Credit Institutions (Chairman: Prof. A. Vaidyanathan) and in consultation with the State Governments, had approved a package for revival of the short-term rural co-operative credit structure. As envisaged in the package, 25 States have entered into memorandum of understanding (MoU) with the Government of India and NABARD and 20 States have amended their respective State Co-operative Societies Acts. As on February 28, 2011, an aggregate amount of `8,460 crore was released by NABARD for recapitalisation of primary agricultural credit societies (PACS) in 16 States as the Government of India's share under the revival package.

Financial Inclusion through Grass-root Co-operatives

91. It was proposed in the Monetary Policy Statement of April 2010 to constitute a committee comprising representatives from the Reserve Bank, NABARD and a few State Governments to study the functioning of well-run PACS, large adivasi multi-purpose co-operative societies (LAMPS), farmers service societies (FSS) and thrift and credit co-operative societies set up under the parallel Self-Reliant Co-operative Societies Acts to gather information on their working and assess their potential to contribute to financial inclusion. The regional offices of the Reserve Bank have since given their inputs. Analysis, consolidation of data and preparation of State-wise reports are in progress and are expected to be completed by end-July 2011.

Malegam Committee Recommendations

92. In the wake of the Andhra Pradesh micro finance crisis in 2010, concerns were expressed by various stakeholders and the need was felt for more rigorous regulation of non-banking financial companies (NBFCs) functioning as micro finance institutions (MFIs). As indicated in the Second Quarter Review of November 2010, a Sub-Committee of the Central Board of the Reserve Bank (Chairman: Shri Y. H. Malegam) was constituted to study issues and concerns in the MFI sector. The Committee submitted its report in January 2011, which was placed in public domain. The Committee, *inter alia*, recommended (i) creation of a separate category of NBFC-MFIs; (ii) a margin cap and an interest rate cap on individual loans; (iii) 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"; and (viii) continuation of categorisation of bank loans to MFIs, complying with the regulation laid down for NBFC-MFIs, under the priority sector. The recommendations of the Committee were discussed with all stakeholders, including the Government of India, select State Governments, major NBFCs working as MFIs, industry associations of MFIs working in the country, other smaller MFIs, and major banks. In the light of the feedback received, it has been decided:

- to accept the broad framework of regulations recommended by the Committee;
- that bank loans to all MFIs, including NBFCs working as MFIs on or after April 1, 2011, will be eligible for classification as priority sector loans under respective category of indirect finance only if the prescribed percentage of their total assets are in the nature of "qualifying assets" and they adhere to the "pricing of interest" guidelines to be issued in this regard;
- that a "qualifying asset" is required to satisfy the criteria of (i) loan disbursed by an MFI to a borrower with a rural household annual income not exceeding ₹60,000 or urban and semi-urban household income not exceeding ₹1,20,000; (ii) loan amount not to exceed ₹35,000 in the first cycle and ₹50,000 in subsequent cycles; (iii) total indebtedness of the borrower not to exceed ₹50,000; (iv) tenure of loan not to be less than 24 months for loan amount in excess of ₹15,000 without prepayment penalty; (v) loan to be extended without collateral; (vi) aggregate amount of loan, given for income generation, not to be less than 75 per cent of the total loans given by the MFIs; and (vii) loan to be repayable by weekly, fortnightly or monthly instalments at the choice of the borrower;
- that banks should ensure a margin cap of 12 per cent and an interest rate cap of 26 per cent for their lending to be eligible to be classified as priority sector loans;
- that loans by MFIs can also be extended to individuals outside the self-help group (SHG)/joint liability group (JLG) mechanism; and
- that bank loans to other NBFCs would not be reckoned as priority sector loans with effect from April 1, 2011.

93. Detailed guidelines in this regard will be issued separately.

Redefining the Priority Sector

94. The Malegam Committee recommended that the existing guidelines on bank lending to the priority sector be revisited. Requests were also received from various quarters in the recent past to relook at the definition of the priority sector, especially when bank finance was being routed through other agencies. It is, therefore, proposed:

- to appoint a committee to re-examine the existing classification and suggest revised guidelines with regard to priority sector lending classification.

SA-DHAN CORE VALUE AND VOLUNTARY MUTUAL CODE OF CONDUCT FOR
MICROFINANCE INSTITUTIONS

INTRODUCTION

Microfinance institutions seek to create social benefits and promote financial inclusion by providing financial services to low income households, including those who were previously excluded. As these institutions build partnerships with their clients and the microfinance sector grows more complex, it is getting increasingly important to define core values and fair practices, so as to ensure that microfinance services are provided in a manner that benefits and respects clients. This document states core values for microfinance (Part-I), a voluntary mutual code of conduct for microfinance institutions to abide by these values (Part-II) and a process of compliance (Part-III). All microfinance institutions, which are members of Sa-Dhan, unanimously and whole-heartedly agree to abide by the core values and the code of conduct as set out hereunder:

Part- I

CORE VALUES IN MICROFINANCE

INTEGRITY

Our mission is to service low-income clients—women and men—and their families, providing them short term and/or long-term access to financial services, that are client focused, designed to enhance their well-being, and delivered in a manner that is ethical, dignified, transparent, equitable and cost effective.

QUALITY OF SERVICE

We believe that our clients deserve fair and efficient microfinance services. We will provide these services to them in as convenient, participatory and timely manner as possible.

TRANSPARENCY

We shall give our clients complete and accurate information and educate them about the terms of financial services offered by us in a manner that is understandable by them.

FAIR PRACTICES

We are committed to ensure that our services to our clients are not unethical and deceptive. In providing microfinance services including lending and collection of dues, we are committed to fair practices, which balance respect for client's dignity and an understanding of a client's vulnerable situation, with reasonable pursuit of recovery of loans.

PRIVACY OF CLIENT INFORMATION

We will safeguard personal information of clients, only allowing disclosures and exchange of such information to others who are authorized to see it, with the knowledge and consent of clients.

INTEGRATING SOCIAL VALUES INTO OPERATIONS

We believe that high standards of governance, participation, management and reporting are critical to our mission to serve our clients and to uphold core social values.

FEEDBACK MECHANISM

We shall provide our clients formal and informal channels for their feedback and suggestions for building our competencies to serve our clients better.

Part-II

VOLUNTARY MUTUAL CODE OF CONDUCT

To ensure that all our activities and dealings with clients are in compliance with the above core values, we all agree to adopt the code of conduct as elaborated hereunder:

2.0 APPLICATION OF THE CODE:

- i) This code applies to all categories of member microfinance institutions - irrespective of their constitution (a society or a trust or company or cooperative society under any state enactment or Multi-State Cooperative Societies Act) - whose principal activity is microfinance.
- ii) This code applies to following activities undertaken by member microfinance institutions:
 - a) Formation of any type of community collectives including self-help groups, Joint liability groups and their federations.
 - b) Providing financial literacy to the clients.

- c) Collection of thrift from clients.
- d) Making arrangement for remittance of funds collected from clients through banking channels or by any other means.
- e) Providing credit services to clients individually or in groups;
- f) Recovery of credit provided to clients for economic activities or for any other purpose for the welfare and benefit of clients.
- g) Business development services including marketing products or services made or extended by the eligible clients or for any other purpose for the welfare and benefit of clients.
- h) Providing insurance or pension benefit products as partners or agents of insurance companies, or pension or mutual fund schemes duly licensed to undertake microfinance or insurance or pensioners' benefit schemes by a competent authority.
- iii) Certain key words used in this code are defined in the Annexure at the end of this code.
- iv) This code comes into effect from 18 January 2007 unless otherwise indicated.

2.1 We all agree to—

- i) Promote and strengthen the microfinance movement in the country by bringing the low-income clients to the mainstream financial sector.
- ii) Build progressive, sustainable and client-centric microfinance institutions in the country to provide integrated financial services to our clients.
- iii) Promote cooperation and coordination among microfinance institutions and other agencies to achieve higher operating standards and avoid unethical competition in order to serve our clients better.

2.2 In order to achieve the aforesaid, we all agree to follow the following practices mentioned below:

2.2.1 INTEGRITY

We agree to—

- i) Act honestly, fairly and reasonably in conducting microfinance activities.
- ii) Conduct our microfinance activities by means of fair competition, not seeking competitive advantages through illegal or unethical microfinance practices. No officer, employee, agent or other person acting on our behalf shall take unfair advantage of anyone by manipulation, concealment, abuse of privileged information, misrepresentation of material facts or any other unfair practice.
- iii) Prominently display the core values and code of conduct on the notice board of head office and all branches, and put systems in place to ensure compliance.
- iv) Ensure that our staff and any person acting for us or on our behalf, are trained or oriented to put these values into practice.

2.2.2 TRANSPARENCY

We agree to—

- i) Disclose to clients all the terms and conditions of our financial services offered in the language understood by the client.
- ii) Disclose the source of funds, costs of funds and use of surpluses to provide truthful information to clients.
- iii) Provide information to clients on the rate of interest levied on the loan, calculation of interest (monthly/quarterly/half-yearly), terms of repayment, and any other information related to interest rates and other charges
- iv) Provide information to clients on the rate of interest offered on the thrift services provided by us.
- v) Provide information to clients related to the premium and other fees being charged on insurance and pension services offered by us as intermediaries.
- vi) Provide periodical statements of our accounts to the clients.

2.2.3 FAIR PRACTICES

We are committed to follow fair practices built on dignity, respect, fair treatment, persuasion and courtesy to clients. We agree to

- i) Provide micro finance services to low income clients irrespective of gender, race, caste, religion or language.
- ii) Ensure that the services are provided using the most efficient methods possible to enable access to financial services by low income households at reasonable cost.
- iii) Recognize our responsibility to provide financial services to clients based upon their needs and repayment capacity.

- iv) Promise that, in case of loans to individual clients below Rs 25,000, the clients shall not be asked to hand over original land titles, house pattas, ration cards, etc as collateral security for loans except when obtaining copies of these for fulfilling “know your customers” norms of the RBI. Only in case of loan to individual clients of Rs 25,000/- and above can land titles, house pattas, vehicle RC books, etc. be taken as collateral security.
- v) Interact with the clients in an acceptable language and dignified manner and spare no efforts in fostering clients’ confidence and long-term relationship.
- vi) Maintain decency and decorum during the visit to the clients’ place for collection of dues.
- vii) Avoid inappropriate occasions such as bereavement in the family or such other calamitous occasions for making calls/visits to collect dues.
- viii) Scrupulously avoid any demeanour that would suggest any kind of threat or violence.
- ix) Emphasize using social collateral which includes various forms of peer assurance such as lending through groups and group guarantees at the village, hamlet or neighbourhood level, or guarantees by relatives, friends, neighbours or business associates; and explain clearly to clients what are the obligations of social collateral.

2.2.4 GOVERNANCE

We agree to—

- i) Observe high standards of governance, ensuring fairness, integrity and transparency by inducting persons with good and sound reputation, as members of Board of Directors. We shall ensure that the majority of the directors are independent directors and/or duly elected representatives of the community we serve, and that we will involve the Board in all policy formulation and other important decisions.
- ii) Ensure transparency in the maintenance of books of accounts and reporting/ presentation and disclosure of financial statements by qualified auditor/s.
- iii) Put in our best efforts to follow the Audit and Assurance Standards issued by the Institute of Chartered Accountants of India (ICAI).
- iv) Place before the Board of Directors, a compliance report indicating the extent of compliance with this Voluntary Mutual Code of Conduct, specifically indicating any deviations and reasons therefore, at the end of every half financial year.

2.2.5 FEEDBACK/ GRIEVANCE MECHANISMS

We agree to—

- i) Establish effective and efficient feedback mechanism
- ii) Take steps to correct any errors and handle complaints speedily and efficiently.
- iii) Provide; where a complainant is not satisfied with the outcome of the investigation into her complaint, she shall be notified of her right to refer the matter to the Ethics and Grievance Redressal Committee constituted by Sa-Dhan.

Part-III COMPLIANCE MECHANISM

3.1 The Board of Directors of Sa-Dhan shall form an independent Ethics and Grievance Redressal Committee to facilitate compliance with this code. The committee shall be constituted of respected and trusted persons from the microfinance sector and other social development sectors, providing guidance and help in resolving any disputes.

3.2 The board of the member microfinance institutions should adopt the core values and the code of conduct on an annual basis.

3.3 In case of a written complaint received by the Ethics and Grievance Redressal Committee regarding non-compliance with the code by any member microfinance institution, the committee shall take the following steps:

- i) Assist in compliance.
- ii) Failing which—
 - a) Formally write to the chief executive of that member microfinance institution to respond to the complaint within **15** days.
 - b) If the chief executive of that member microfinance institution fails to respond within **15** days of the receipt of the communiqué, the matter will be formally communicated to the board of that

microfinance institution in writing to seek a response.

c) If the board does not respond within the **15** days of the receipt of the communiqué, the membership of that microfinance institution shall be suspended till further decision of the committee.

d) If the committee decides it is necessary to expel the microfinance institution from the membership of Sa-Dhan, it shall recommend the expulsion to the Board of Directors of Sa-Dhan.

e) The Board of Directors of Sa-Dhan shall then take the appropriate decision and if they decide to expel the member, the name of the expelled member will be published on the website of Sa-Dhan.

ANNEXURE

“Clients” refers to those served by the microfinance institutions - women and men from socially, economically and politically disadvantaged sections of society, including small and marginal farmers, oral lessees, tenants, sharecroppers, disadvantaged social groups, artisans, and persons engaged in small and tiny economic activities.

“Microfinance Services” means the following activities undertaken by Sa-Dhan’s member microfinance institutions:

i) Formation of any type of community collectives including self-help groups,

Joint liability groups and their federations;

ii) Collection of thrift from clients;

iii) Making arrangement for remittance of funds collected from clients, through banking channels or by any other means;

iv) Providing credit services to clients, individually or in groups.;

v) Recovery of credit provided to clients for economic activities or for any other purpose for the welfare and benefit of clients;

vi) Business development services including marketing products or services made or extended by the eligible clients or for any other purpose for the welfare and benefit of clients.

vii) Providing insurance or pension benefit products as partners or agents of insurance companies or pension or mutual fund schemes duly licensed to undertake micro finance or insurance or pensioners’ benefit schemes by a competent authority

“Thrift” means savings of clients, who have become members of self-help groups, other than public deposits.

MICROFINANCE INSTITUTIONS NETWORK (MFIN) CODE OF CONDUCT FOR

MFIN MEMBERS

As all MFIN Member MFIs are regulated by the Reserve Bank of India (RBI), they are already required to follow all prudential norms as well as consumer protection practices laid down by the RBI. This Code of Conduct is designed to ensure that the RBI Guidelines are followed in both letter and spirit, and in some matters, lays down additional requirements.

A. FAIR PRACTICES WITH BORROWERS

i. Communication of charges

All members should clearly convey to the borrowers the following terms of the loan (at the minimum):

- a. All the important terms and conditions of the loan agreement
- b. Declining rate of interest
- c. Processing fee
- d. Any other charges
- e. Security or any other deposit.
- f. Systematic advance collections
- g. Total charges recovered for insurance coverage risks covered
- h. Any other services rendered and charges for the same

The communication should be in writing through any/various of the following ways:

- Individual sanction letter
- Loan card
- Loan schedule
- Passbook
- Through Group/Centre meetings (Details can be printed on a paper and all borrowers can sign on the same as acknowledgement of their acceptance)

The communication should be in a medium understood by the borrower

ii. Nature and amount of charges

The code of conduct will not specify the nature and quantum of charges to be charged by individual MFIs. However, the transparency of the same should be ensured as covered in clause (I.i.)

iii. Recovery mechanism

a. Though each MFI tries to ensure on-time recovery of dues, it is imperative that they shall not use any abusive, violent, or unethical methods of collection and recovery efforts should be in line with guidelines issued from RBI from time to time.

b. A valid receipt (in whatever form as decided by each member) should be provided for each collection from the borrower.

B. MULIPLE LENDING & LENDING LIMITS

a. The maximum number of MFIs who can lend to one client is three, and the maximum loan outstanding that all the three MFIs together can have to a single client is restricted to Rs. 50,000/- at any point in time.

b. This cap will cover only unsecured loans given within the joint liability group mechanism or mutual guarantee of all types.

c. Any secured loans or individual business loans will not be covered under this cap.

d. The code will not cover the credit norms to be fixed by individual member MFIs.

C. DATA SHARING/ INCIDENT SHARING

a. In addition to the formatted data supplied to the Credit Bureaus CIBIL and High Mark, and hence available to all the members through the bureaus, it should be agreed to participate in a forum to share qualitative credit information.

b. Whenever any member comes across Incidents of High Default (IHD), the member should inform the Association of the same so that the other members are made aware of it.

c. However whether any other member would further lend to clients in such an area would be the choice of each individual MFI based on their credit policies

d. In connection with 'c' above, it is agreed that each member will make his decision transparent to the remaining members.

e. In case of any Incidents of High Default is faced by one MFI, all members shall cooperate in a recovery drive and restrain lending in that area till things are streamlined.

D. RECRUITMENT

a. The code covers all MFI staff, in particular field staff. Field staff is defined as all branch staff including the branch manager.

b. Any member MFI should have at least 50 percent of its net new recruitment in any particular year as people whose immediate previous job has not been with another member MFI.

c. As a matter of free and fair recruitment practice, there will be no restriction on hiring of staff from other MFIs by legitimate means in the public domain like general recruitment advertisements in local newspapers, web advertisements on site, walk-in interviews, etc.

d. Whenever a member MFI recruits from any other member MFI, it will be mandatory to seek a reference check from the previous employer.

e. All member MFIs should agree to provide within two weeks the reply to the reference check correspondence from another member MFI.

f. All member MFIs also agree not to recruit anybody from the other members without the relieving letter / no due certificate from the previous MFI employer.

g. All member MFIs agree to provide such relieving letter / no due certificate to the outgoing employee in case he has given proper notice, handed over the charge and settled all the dues towards the MFI.

h. The relieving MFI is within its rights to insist on an actual serving of notice for 30 days, but the rest of the notice period pay may be reimbursed by the recruiting MFI. It is the prerogative of the relieving MFI to waive part/full of the notice period or accept cash consideration in lieu.

i. It is also agreed that any staff member who is discovered to have lied about his background of working with any other MFI, will be asked to leave immediately by the recruiting MFI.

E. WHISTLE BLOWING

a. Any person or MFIN member is entitled to report an incident of improper conduct an MFIN member to the Code of Conduct Enforcement Committee (CCEC) of MFIN.

b. The CCEC shall investigate such instances within 30 calendar days of receiving such report. For this purpose the CCEC may depute its own staff or use the services of outsourced agencies as the CCEC thinks fit.

F. ENFORCEMENT MECHANISM

a. If the CCEC finds the charge prima facie correct, it shall give notice to both the parties for a written representation for the charge within 15 days

b. If the CCEC finds that the contravening Member admits to the contravention and undertakes not to repeat the same then the CCEC may drop further proceedings

c. However if the Member does not admit to contravention or does not undertake to stop further contraventions, the CCEC shall hold a hearing with both the parties present within a further period of 15 days.

d. If the action of the member is found to be in contravention to the Code of Conduct, the following escalation will come into effect, with a gap of 15 days at each stage, in case no corrective action has been taken.

- Communication to the errant member's MFIN representative.
- Communication to the Chief Executive of the respective MFI.
- Communication to the Chairman of the Board of Directors of the errant MFI.
- Communication to each member of the Board of Directors of the errant MFI.
- Communication to the institutional investors of the errant MFI
- Communication to the institutional lenders of the errant MFI
- Communication to the RBI about the errant MFI

e. The errant MFI as well as the complainant can appeal to the Board of MFIN against the decision of the CCEC within 15 days. The appeal will be adjudicated by the Board of the MFIN in its next meeting.

f. The escalation mechanism will be kept on hold till such time an appeal is adjudicated upon.

g. In case no corrective action is taken by the errant member, within 1 month of the final escalation, the Board of MFIN is entitled to suspend the errant MFI from the membership of MFIN for a period or expel the member from MFIN. While suspension can be approved by the Board with a two-thirds majority, the decision for expulsion would require a two-thirds majority in the Board favouring it and a further approval by the General Body with two-thirds majority either present and voting in person or voting through any written form including e-mail and fax.

h. This action under 'g' would then be communicated to all important stakeholders, along with the reasons.

G. OMBUDSPERSON MECHANISM

a. MFIN Board will appoint one or two individuals of high professional reputation and integrity, as Ombudspersons, in each of the six RBI regions – East, West, Central, South, North and Northeast, to provide an independent mechanism to individual consumers or staff members to complain against an MFI and seek redressal. They will be given adequate secretarial support by MFIN.

b. Any person desiring to complain against an MFIN Member shall write a letter to the Ombudsperson

c. The Ombudsperson, on receipt of the complaint will send copies to the Chairman of the CCEC and the Chairman of MFIN Board. The Ombudsperson can cause an initial enquiry to be conducted to determine *prima facie* if there exists a case for investigation

d. If the Ombudsperson does not feel that there exists a case for further investigation, he may accordingly write back to the complaining person with copies marked to the Chairman of MFIN and the Chairman of the CCEC (unless the matter pertains to the Chairman himself in which case it shall be marked to the Vice Chairman)

e. If the Ombudsperson feels that there exists a *prima facie* case for investigation, then he shall cause an investigation to be made using the services of the Secretariat of the MFIN.

f. The Ombudsperson may also require the presence of parties to the dispute in which case, such meetings shall normally be held at the office of the Ombudsmen unless the disputing parties mutually agree to any other place for such meetings

g. If after reasonable notice, any party to the dispute fails to be present for such meetings or fails to provide written responses to the queries of the Ombudsperson, then the Ombudsperson shall proceed to give his decision with the materials available with him

h. The Ombudsmen will have the power to ask the errant MFI to make good any damages incurred by the consumer, and in addition impose a fine on the MFI, commensurate with the seriousness of the complaint. After investigation and such inter-party meetings as the Ombudsperson determines, the Ombudsperson shall deliver his decision on the dispute in front of him and such decision shall be communicated in writing to all the parties to the dispute as well as to the Chairman of the CCEC and the Chairman of MFIN. Such decisions of the Ombudsperson shall be final and binding on all the parties involved.

i. However if any of the parties to the dispute desire to contest the decision of the Ombudsperson, then they may give the same in writing to the Chairman of MFIN who shall place it before the next General Body of the members and two-thirds of the Members may take the final decision on the dispute either by voting in person or through other written forms including e-mails and fax.

j. In extreme case, the Ombudsperson may also recommend suspension or expulsion from membership of the errant MFI to the MFIN Board. This will then follow the same process as specified in clause (F.g.) above.

H. AMENDMENTS TO THIS CODE OF CONDUCT

Any amendments to this Code of Conduct will be adopted through the due process of first, a Board majority approval and thereafter a ratification by a majority of the General Body.

THE SMART CAMPAIGN CLIENT PROTECTION PRINCIPLES

(REVISED AS OF JULY 2011)

Appropriate product design and delivery

Providers will take adequate care to design products and delivery channels in such a way that they do not cause clients harm. Products and delivery channels will be designed with client characteristics taken into account.

Prevention of over-indebtedness

Providers will take adequate care in all phases of their credit process to determine that clients have the capacity to repay without becoming over-indebted. In addition, providers will implement and monitor internal systems that support prevention of over-indebtedness and will foster efforts to improve market level credit risk management (such as credit information sharing).

Transparency

Providers will communicate clear, sufficient and timely information in a manner and language clients can understand so that clients can make informed decisions. The need for transparent information on pricing, terms and conditions of products is highlighted.

Responsible pricing

Pricing, terms and conditions will be set in a way that is affordable to clients while allowing for financial institutions to be sustainable. Providers will strive to provide positive real returns on deposits.

Fair and respectful treatment of clients

Financial service providers and their agents will treat their clients fairly and respectfully. They will not discriminate. Providers will ensure adequate safeguards to detect and correct corruption as well as aggressive or abusive treatment by their staff and agents, particularly during the loan sales and debt collection processes.

Privacy of client data

The privacy of individual client data will be respected in accordance with the laws and regulations of individual jurisdictions. Such data will only be used for the purposes specified at the time the information is collected or as permitted by law, unless otherwise agreed with the client.

Mechanisms for complaint resolution

Providers will have in place timely and responsive mechanisms for complaints and problem resolution for their clients and will use these mechanisms both to resolve individual problems and to improve their products and services.

ANNEX I – ABSTRACTS

ENGLISH

Increasing commercialisation of the competitive Indian microfinance market has exposed the shortcomings of the commonly used microfinance model, the joint-liability-group model. While it was designed to address the lack of information of lenders, it failed to address the informational asymmetry to the disadvantage of consumers, which is equally important. Consumer protection is essential to overcome this asymmetry. This need is not unique to the microfinance market, but applies equally to financial products for middle-class clients.

Unfortunately, a unified regulation of the Indian microfinance sector has not yet been passed. While the draft of the central microfinance bill appoints the RBI as the main regulator, it has not been adopted yet. It would be needed in order to regulate the sector nationwide, so that banks and investors can readapt their strategies and eventually start lending to struggling MFIs again. I portrayed the efforts of the regulator, funders, institutions and industry associations to meet this need for regulation and came to the conclusion that none of these efforts can replace a unified legal framework

GERMAN

Die Kommerzialisierung und der Wettbewerb am indischen Mikrofinanzmarkt haben gezeigt, dass das hauptsächlich genutzte Mikrofinanzmodell mangelhaft ist. Dieses wurde entwickelt, um die Informationsmängel der Mikrofinanzinstitutionen auszugleichen. Dabei wurde aber übersehen, dass auch die Kunden nur über mangelhafte Informationen verfügen. Um dieses Informationsdefizit auszugleichen, ist Konsumentenschutz erforderlich, wie er auch bei Finanzprodukten für die Mittelklasse üblich ist.

Eine einheitliche Regulierung des Mikrofinanzmarktes in Indien fehlt. Der Entwurf eines einheitlichen Mikrofinanzgesetzes sieht die indische Nationalbank als Regulierungsbehörde vor, wurde aber noch nicht vom Parlament verabschiedet. In dieser Arbeit werden der Stand der Regulierung und die Konsumentenschutzmaßnahmen verschiedener Akteure wie Geberinstitutionen, Investoren, Banken, Industrieverbänden und Mikrofinanzinstitutionen dargestellt. Deren Bemühungen können eine gesetzliche Regulierung des Sektors allerdings nicht ersetzen.

ANNEX II – CV

MAG. GISELA KRISTOFERITSCH

GEBOREN 1986 IN WIEN
ÖSTERREICHISCHE STAATSBÜRGERIN

AUSBILDUNG

10/2004 –	UNIVERSITÄT WIEN Individuelles Diplomstudium Internationale Entwicklung
03/2005 - 05/2010	UNIVERSITÄT WIEN Diplomstudium Rechtswissenschaften
09/2008 - 06/2009	UNIVERSITÄT MAASTRICHT Erasmusaufenthalt
06/2004	BG XIX, GYMNASIUMSTRASSE, WIEN Matura

ARBEITSERFAHRUNG

07/2011 -01/2012	OBERLANDESGERICHT WIEN Rechtspraktikantin
10/2010 - 05/2011	GTZ / GIZ, NEW DELHI PROJEKT 'CONSUMER PROTECTION AND SUSTAINABLE CONSUMPTION IN INDIA' Praktikantin
07/2010 - 09/2010	STAATSANWALTSCHAFT WIEN Rechtspraktikantin
02/2010 - 04/2010	ACCION INTERNATIONAL/YES BANK, MUMBAI, DEPARTMENT DEVELOPMENT BANKING (YES SAMPANN) Praktikantin
04/2009 - 05/2010	UNIVERSITY OF MAASTRICHT, PUBLIC LAW DEPARTMENT Student Assistant
07/2008	BUNDESKANZLERAMT, SEKTION V, VERFASSUNGSDIENST Praktikantin
08/2008, 09/2007	CHSH PARTNERSCHAFT VON RECHTSANWÄLTEN Praktikantin

SPRACHEN

DEUTSCH (Muttersprache) - ENGLISCH (sehr gut) - FRANZÖSISCH (gut) - ITALIENISCH (gut)