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Building Sustainable Microfinance Institution in India in Changing Regulatory Environment

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Microfinance has been accepted as a tool towards poverty alleviation and financial inclusion in most of the countries. There is a need to bridge the gap between down trodden people and credit & finance facilities accessibility. Accessibility to finance and micro credit to the economically weaker section of the society has witnessed a evolution right from ancient period's community oriented 'Pawn Shops' founded by Franciscan monks to the modern era's Muhammad Yunus's 'Grameen Bank' revolution in Bangladesh. Microfinance Institutions have provided a viable option for economically weaker section, especially in rural areas where people find it difficult to avail financial services like micro credit, savings account etc. in absence of various documents and collateral.

Sustainability in itself should be envisaged in a more comprehensive sense then just financial sustainability. Micro Finance Institutions (MFIs) need to access the viability of demand, its ownership, governance, and legal & regulatory framework as a whole. The sustainability of MFIs may not be sufficient unless a fully developed micro-finance sector is established on sustainable lines. An endeavour has been made by the author in the paper to appraise what comes in the way of making Indian MFIs sustainable and how can a good regulatory framework may facilitate this.

Key Words: Microfinance, Sustainability, Regulatory Framework, Micro Credit, Financial Sustainability

Introduction

Microfinance has been accepted as a tool towards poverty alleviation and financial inclusion in most of the countries. There is a need to bridge the gap between down trodden people and credit & finance facilities accessibility. Accessibility to finance and micro credit to the economically weaker section of the society has witnessed a evolution right from ancient period's community oriented 'Pawn Shops' founded by Franciscan monks to the modern era's Muhammad Yunus's 'Grameen Bank' revolution in Bangladesh. Microfinance Institutions have provided a viable option for economically weaker section, especially in rural areas where people find it difficult to avail financial services like micro credit, savings account etc. in absence of various documents and collateral.

The present research work is an effort to review the government's new regulations on MFIs (Micro Finance Institutions) introduced after Andhra crisis, in the light of sustainability of MFIs. Andhra Crisis 2010, which happened in Andhra Pradesh (one of the leading state of India), was one of the first place which saw development of MFIs in the decade (2000-10). The Andhra Pradesh crisis was a turning point in public assessment of microfinance, with a suicide wave caused by widespread over-indebtedness badly tarnishing the sector's image in India as well as abroad. In 2010 the global microfinance sector was shaken by the crisis in India, which saw repayment rates plummet and led towards reconsideration of microfinance as a tool for poverty alleviation.

Sustainability here refers to something far more wide and vast then just financial sustainability. Micro Finance Institutions (MFIs) need to access the viability of demand, its ownership, governance, and legal & regulatory framework as a whole. The sustainability of MFIs may not be sufficient unless a fully developed micro-finance sector is established on sustainable lines. An effort has been made by the author in the paper to appraise the challenges faced by Indian MFIs in attaining sustainability and how does a good regulatory framework facilitate it.

The need of the poor has resulted in evolution of microfinance industry, it is has been promoted

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primarily as a support system which provides opportunity to the poor for various income generating purposes. However over past decade, MFI's have looked beyond traditional sources of fund generation to increase their penetration. From donations, cheap loans by banks to raising funds through IPO's MFI's have come a long way.

Achieving self-sustainability to achieve greater financial inclusion has been the objective of MFI's while undertaking all fund raising activities. With higher operating cost and gruesome demands of investors, MFI's outlook has become skewed putting burden on borrowers by increasing margins thus increasing profits. Profit is not a curse however the means and end i.e. how it is generated and where it is used is very important. Though it is complicated as investor will always stake claim on profits and rightly so, further MFI's will play to the gallery to ensure future cash flow. But in this entire economics of building capital, the other capital i.e. social capital is getting neglected thus questioning the very genesis of MFI's.

Literature Review: Sustainability of Microfinance Institutions

Sustainability has become one of the important aspects in contemporary times in every part of life. Especially in case of Microfinance institution sustainability is very crucial issue as MFIs are usually established to fulfil a mission of reaching credit and financial services to the poor who are otherwise unreached by mainstream FIs. Thus MFI try to simultaneously achieve the twin goal of access (by the poor) and sustainability (of the institution or its micro-credit portfolio). In general, sustainability of microfinance indicates permanency of the program. In case of microfinance, sustainability can be defined as institutional and can relate to organizational, managerial and financial aspects. However, financial sustainability of microfinance institutions has become the critical point of focus in microfinance studies.

Hulme and Mosley(1996) indicated that MFIs outreach is a perceived goal from social and business point of view. When question of sustainability of MFIs come, it is observed that only few percent of the MFIs are sustainable to run operation without subsidies. In defining sustainability of microfinance, Woller et al (1999) used the definition offered by Brinkerhoff, which stated sustainability could as the "ability of a program to produce outputs that are valued sufficiently by beneficiaries and other stakeholders that the program receives enough resources and inputs to continue production". Pollinger et al (2007) defined sustainability as the ability to cover annual budgets including grants, donations, and other fundraising. Acharya and Acharya (2006) considered view of Sharma and Nepal (1997) where sustainability indicates excess of operating income over operating cost. The concept is from the banker's perspective and it includes both financial viability and institutional viability of MFIs.

Therefore, self-sufficiency is an indication for the financial sustainability of the MFIs. Ledgerwood (1999) indicated in his research that, as the microfinance industry matures, the definition of the self-sufficiency has commenced to slender and currently sustainability refers only two levels of sustainability by the most of the people associated with this industry. These are Operational Self Sufficiency (OSS) and Financial Self Sufficiency (FSS).

OSS indicates whether enough revenue has been earned to cover the MFI's direct costs, excluding the cost of capital but including actual financing costs. Thus, formula for calculating OSS is: [Operating Income/ (Operating Expenses + provision for loan losses)]. FSS on the other hand portray the actual financial health of MFIs. Thus, FSS includes cost of capital (adjusted) apart from the components in OSS. On the other hand Pollinger et al (2007) refers self-sufficiency as to organizations that can survive and add to their asset base wholly on the basis of income derived from their lending and related operations.

Morduch (1999) indicate that Subsidy is a crucial factor in analysing sustainability of microfinance in general and MFIs in particular. Even front line institution like Grameen Bank of Bangladesh may experience a high repayment rate, and also depends on subsidies due to higher value towards social sector. Seibel and Torres (1999) It is also learned from the Philippines that replication of Grameen-type MFIs can be sustainable and can substantially increase their outreach, but not by fully subsidy independent.

Numbers of empirical works in different settings has strengthened the literature base on sustainability and self-sufficiency of microfinance. Brewer et al.'s (1996) researched into the performance of Small Business Investment Companies (SBICs) between 1958 and 1996 and

highlighted the potential dangers of subsidized funding. Regarding pricing and self-sufficiency, Gulli (1998) suggests that institutions must charge sufficient interest rates to cover their costs. Tang, et al (2002) suggest that one reason for continued dependence on subsidies is unwillingness to charge the maximum legally allowable interest rates and fees that would allow programs to cover as much expense and risk cost as possible from operations. Acharya and Acharya (2006) in their study in Nepal found that clients did not think about institutional sustainability, rather think of individual sustainability and this resulted in 'trickle-up' of microfinance institution to be institutionally sustainable.

Research Gap: A wide range of study has been conducted in order to study the sustainability of microfinance institution in countries like Nepal, Bangladesh, Philippines, etc. And in all the studies the major emphasis is on operational self sustainability and financial self sustainability. After going through the available literature on sustainability of MFIs, researcher realized that there is dearth of research in the area of sustainability of Indian microfinance Institution.

In this paper researcher has focused on Sustainability of micro financial institutions their genesis, current ambit of regulations on them.

Objectives of the Study:

1. To Study the existing business model of MFIs
2. To study regulatory frame work under which MFI's work.
3. To Study the sustainability of MFIs in India under the prevailing regulatory framework

Existing models of microfinance institutions:

Following are few preferred models adopted by MFI's world over:

Solidarity lending is a practice where collective borrowing is done by small group and they motivate each other to repay. It is an important building block of microfinance. Solidarity lending lowers the costs to a financial institution related to assessing, managing and collecting loans, and can eliminate the need for collateral.

A self-help group (SHG) is a village-based financial intermediary usually composed of 10-20 local women or men. A mixed group is generally not preferred. Most self-help groups are located in India, though SHGs can also be found in other countries, especially in South Asia and Southeast Asia. Members make small regular savings contributions over a few months until there is enough capital in the group to begin lending. Funds may then be lent back to the members or to others in the village for any purpose. In India, many SHGs are 'linked' to banks for the delivery of microcredit.

Peer-to-peer lending also known as person-to-person lending, peer-to-peer investing, and social lending; is the practice of lending money to unrelated individuals, or "peers", without going through a tradition financial intermediary such as a bank or other traditional financial institution.

Grameen Model This is one model which revolutionized the entire Micro finance industry and made people stand up & notice what MFI's can achieve in accomplishing financial inclusion of the poor. Its concept is simple

a) Lending money to the poorest women for income generating activity,

b) Without collateral.

c) So she can help herself out of poverty.

- The Grameen model emerged from the poor-focused grassroots institution, Grameen Bank, started by Prof. Mohammed Yunus in Bangladesh. It essentially adopts the following methodology:A bank unit is set up with a Field Manager and a number of bank workers, covering an area of about 15 to 22 villages. The manager and workers start by visiting villages to familiarize themselves with the local milieu in which they will be operating and identify prospective clientele, as well as explain the purpose, functions, and mode of operation of the bank to the local population

- Groups of five prospective borrowers are formed; in the first stage, only two of them are eligible for, and receive, a loan. The group is observed for a month to see if the members are conforming to rules of the bank.

- Only if the first two borrowers repay the principal plus interest over a period of fifty weeks do other members of the group become eligible themselves for a loan.

- Because of these restrictions, there is substantial group pressure to keep individual records clear. In this sense, collective responsibility of the group serves as collateral on the loan.

The Group Model's- basic philosophy lies in the fact that shortcomings and weaknesses at the individual level are overcome by the collective responsibility and security afforded by the formation of a group of such individuals.

Village banks are community based credit and savings associations. They typically consist of 25 to 50 low income individuals who are seeking to improve their lives through self-employment activities. Initial loan capital for the village bank may come from external source, but the members themselves run the bank: they choose their members, elect their own officers, establish their own by-laws, distribute loans to individuals, and collect payments and saving. Their loans are backed, not by goods or property, but by moral collateral: the promise that the group stands behind each individual loan.

The individual model is, in many cases, a part of a larger 'credit plus' program me, where other socio-economic services such as skill development, education, and other outreach services are provided.

Existing Regulatory framework and guidelines (Reserve Bank of India):

Regulations can be restrictive as well as reformist. It's a thin line which regulators have to walk to protect both the ends of market/economy i.e. the investor and the borrower. A tightened noose may result in scaring away investors eventually leading to drying funds which can be disbursed contrarily a liberal policy may result in MFI's playing in to investors hand and going for profits thus levying entire burden on borrower , defeating the entire point of microfinance.

To address these issues and to clear the air post Andhra Pradesh debacle RBI came out with fresh directives on priority sector lending by banks to MFI's in July 2013

Bank loans to MFIs for on-lending

A) Bank credit to MFIs extended on, or after, April 1, 2011 for on-lending to individuals and also to members of Self Help Groups(SHGs) / Joint Liability Groups(JLGs) will be eligible for categorization as priority sector advance under respective categories viz., agriculture, micro and small enterprise, and 'others', as indirect finance, provided not less than 85% of total assets of MFI (other than cash, balances with banks and financial institutions, government securities and money market instruments) are in the nature of "qualifying assets". In addition, aggregate amount of loan, extended for income generating activity, is not less than 70% of the total loans given by MFIs.

B) A "qualifying asset" shall mean a loan disbursed by MFI, which satisfies the following criteria:

- The loan is to be extended to a borrower whose household annual income in rural areas does not exceed INR 60,000/- while for non-rural areas it should not exceed INR 1,20,000/-.
- Loan does not exceed INR 35,000/- in the first cycle and INR 50,000/- in the subsequent cycles.
- Total indebtedness of the borrower does not exceed INR 50,000/-.
- Tenure of loan is not less than 24 months when loan amount exceeds INR 15,000/- with right to borrower of prepayment without penalty.
- The loan is without collateral.
- Loan is repayable by weekly, fortnightly or monthly installments at the choice of the borrower.

C) Further, the banks have to ensure that MFIs comply with the following caps on margin and interest rate as also other 'pricing guidelines', to be eligible to classify these loans as priority sector loans.

- Margin cap at 12% for all MFIs. The interest cost is to be calculated on average fortnightly balances of outstanding borrowings and interest income is to be calculated on average fortnightly balances of outstanding loan portfolio of qualifying assets.
- Interest cap on individual loans at 26% per annum for all MFIs to be calculated on a reducing balance basis.
- Only three components are to be included

in pricing of loans viz., (a) a processing fee not exceeding 1% of the gross loan amount, (b) the interest charge and (c) the insurance premium.

- The processing fee is not to be included in the margin cap or the interest cap of 26%.
- Only the actual cost of insurance i.e. actual cost of group insurance for life, health and livestock for borrower and spouse can be recovered; administrative charges may be recovered as per IRDA guidelines.
- There should not be any penalty for delayed payment.
- No Security Deposit/ Margin are to be taken.

One of the regrets MFIs have that, they do not have access to the same low cost funds/deposits as the banks or NBFC have, as it is very hard for them to meet the stringent guidelines laid down by RBI. Following are some norms with recommendations from Melagam Committee which have to be fulfilled by MFIs to become Non-Banking Finance Companies(NBFC):-

Directions for modification of Non-Banking Finance Companies (NBFC) to Micro Finance Institutions (MFIs)

Capital requirement Entry Point Norms

Existing NBFCs

a. All registered NBFCs intending to convert to NBFC-MFI must seek registration with immediate effect and in any case not later than October 31, 2012, subject to the condition that they shall maintain Net Owned Funds (NOF) at INR.3,00,00,000 by March 31, 2013 and at INR.5,00,00,000 by March 31, 2014, failing which they must ensure that lending to the Microfinance sector i.e. individuals, SHGs or JLGs which qualify for loans from MFIs, will be restricted to 10 per cent of the total assets.

b. In order to provide encouragement to NBFCs operating in North Eastern Region, the minimum NOF is to be maintained at INR.1,00,00,000 by March 31, 2012 and at INR.2,00,00,000 by March 31, 2014.

New Companies- All new companies desiring NBFC-MFI registration will need a minimum Net Owned Fund (NOF) of INR.5, 00, 00,000 except those in the North Eastern Region of the country which will require Net Owned Fund (NOF) of INR.2, 00, 00,000 till further notice, as hitherto and would comply, from the beginning, with all other criteria laid out in the following paragraphs.

Qualifying Assets

NBFC-MFIs are required to maintain not less than 85 per cent of their net assets as Qualifying Assets.

NBFC-MFIs were also required to ensure that the aggregate amount of loans given for income generation is not less than 75 per cent of the total loans extended.

Multiple Lending and Indebtedness-It is clarified that a borrower can be the member of only one SHG or one JLG or borrow as an individual. He can thus borrow from NBFC-MFIs as a member of a SHG or a member of a JLG or borrow in his individual capacity.

Ensuring Compliance with Conditionality - Lending MFIs will have to ensure compliance with, among others, conditionality relating to annual household income levels (INR 60,000/- for rural and INR 1,20,000/- for urban and semi urban households), total indebtedness (not to exceed INR 50,000/-), membership of SHG/JLG, borrowing sources (as stipulated in para 6.4 above) as well as percentage of qualifying assets and percentage of income generating asset (as stipulated in para 6.3 I & II above.)

Pricing of Credit-As per the Malegam Committee recommendations, the interest rate cap on loans given by MFIs has been fixed at 26 per cent, under guidelines issued on December 2, 2011. However, since borrowing costs are dynamic and may exceed the costs envisaged when the Committee recommendations were made, it may be difficult for MFIs which are borrowing at rates higher than envisaged at that time to operate along viable lines, if interest rate is capped at 26 per cent. Therefore, to allow for operational flexibility, NBFC-MFIs will ensure that the average interest rate on loans during a financial year does not exceed the average borrowing cost during that financial year plus the margin, within the prescribed cap.

Capital Adequacy, Asset Classification and Provisioning Norms-In view of the problems being faced by MFIs in Andhra Pradesh many of them have had to provide sizeable amounts towards the non-performing assets in the state. To

reflect the true and fair picture of the financials of the NBFC-MFI in the Balance Sheet, the provisioning made towards the Asset Profile (AP) portfolio should be as per the current provisioning norms. However, for the calculation of Capital to risk assets ratio (CRAR), the provisioning made towards AP portfolio shall be notionally reckoned as part of NOF and there shall be progressive reduction in such recognition of the provisions for AP portfolio equally over a period of 5 years. Accordingly 100 per cent of the provision made for the AP portfolio as on March 31, 2013 would be added back notionally to Net Owned Fund(NOF) for Capital to risk assets ratio (CRAR) purposes as on that date. This add-back would be progressively reduced by 20 per cent each year i.e. up to March 2017. No write-back or phased provisioning is permissible. Provisioning for the non-AP portfolio will be as per the December 2, 2011 circular, with effect from April 1, 2013. Capital adequacy on non-AP portfolio and the notional AP portfolio (outstanding as on the balance sheet date less the provision on this portfolio not notionally added back) will have to be maintained at 15 per cent of the risk weighted assets.

Customer Protection Initiatives- All elements of the Fair Practices Code issued by the Bank vide DNBS.PD.CC.No.286/03.10.042/2012-13 dated July 2, 2012 will need to be adhered to by the MFIs.

Formation of SRO -The Malegam Committee has recommended greater responsibility to be placed on industry associations for monitoring of regulatory compliance. All NBFC-MFIs will have to become member of at least one Self-Regulatory Organization (SRO) which is recognized by the Reserve Bank and will also have to comply with the Code of Conduct prescribed by the SRO.

Monitoring of Compliance-The responsibility for compliance to all regulations prescribed for MFIs lies primarily with the NBFC-MFIs themselves. The industry associations/SROs will also play a key role in ensuring compliance with the regulatory framework.

Suggestions for Building Sustainable MFIs in India

On the basis of literature reviewed by researcher and extensive study of existing regulatory framework applicable for MFIs, we have come up with the following recommendations, which may help to improve the sustainability condition of MFIs in India:-

a) Need to Enact/ Amend Laws and Regulations

b) Changes in the Acts governing Small Industrial Development Bank of India (SIDBI), National Bank for Agriculture & Rural Development (NABARD), and Housing and Development Corporation (HUDCO).

c) Tax benefits need to be extended to the microfinance sector

d) Government initiative should be taken to maintain a data base which can be used and updated by MFI's to lower redundancy and thus reducing overall Operating Self Sustainability.

e) Using the current channels of NGO's for sustained training and development to ensure capability building and timely repayment of loans as well.

f) Making available more lending funds to MFIs .

g) Simplify foreign investment regulations to enable MFIs to raise foreign equity

h) Small Industrial Development Bank of India (SIDBI), National Bank for Agriculture & Rural Development (NABARD), and Housing and Development Corporation (HUDCO) should also consider making an equity investment in MFIs so as to strengthen their capital structure as well as give greater supervision.

i) While development finance institutions in India are getting interested in micro-credit, for various reasons they are not yet in a position to provide equity funding to MFIs. For example, NABARD is not allowed to invest in equity under the NABARD Act, 1982. SIDBI though allowed to invest in equity, it has recently established a special foundation for micro-finance but

Conclusions

Micro-finance is defined by the process of formulating groups within the community to assist poverty stricken people by lending them money without the requirement of collateral. To provide micro-finance and other support services, MFIs should be able to sustain themselves over a long period of time.

A three track approach should be adopted to promote the microfinance sector in India:

1. Provide incentive to existing mainstream financial service providers,
2. Encourage new microfinance institutions to enter and expand their services by providing them with amiable policies, and finally
3. By creating, a network of community-based development financial institutions (CDFIs), from the grassroots with the help of NGOs.

This paper states strongly that India is one the largest emerging market for microfinance. However, the demand needs to be organised and converted into effective demand. The requirement of credit by the poor should be backed by willingness to repay for those services. Only then demand can be sustainable. MFIs have to offer sustainable financial services and reach a stage of high access and high sustainability. Mainstream banks are giving tough price competitions as they are able to cross-subsidise their micro-credit operations. And thus they are able to charge lower interest rates.

The paper argues in favour of a graduated regulatory framework for MFIs in India, starting with minor regulation at the small scale to full prudential regulation above INR 20 million business volumes. MFIs should be regulated but regulation should not hamper financial sustainability.

Within the existing regulatory frame work it is very difficult for MFI's to survive the vicious circle i.e.

- Fund generation through capital market to cater bigger areas to increase financial inclusion
- Distributing the generated fund aggressively at high interest rates to keep investors interest to ensure future supply of funds
- Losing the focus from its core job of management of funds(providing counseling & advice for income generating activities) to ensure timely repayment and building social capital rather than using coercive methods for repayment of loans pushing the poor to become poorest or creating a situation like Andhra debacle.

Thus a stronger emphasis should be on creating a proper repayment cycle after studying the income model used for proposed fund. Though the Regulatory guidelines are an effort to empower the MFI's to generate low cost funds from alternative sources, a new set of regulatory frame work should be built exclusively for MFI's.

Despite of the fact the MFIs can bring about sustainable cost model of financial inclusion along with local expertise on employment and revenue generation products. The NBFC modifications of MFIs are quite harsh on small non-profitable NGOs/MFIs.

The regulatory guidelines are step forward to empower the MFIs to raise low cost funds, so that the benefit of the same can be channelized towards the needy people.

Though, RBI has laid down guidelines to protect investor's interest and economy on the whole, but sometimes the rules itself turnout to be a major obstacle in non-profit MFIs effort to gather cheap funds as they can not comply with huge requirement of Net Owned Fund (NOF). A sincere effort has to be made to create a different and specific set of regulation for MFIs, rather than modifying the current periphery of regulations of existing NBFCs.

Researcher concludes this paper with a set of very detailed and specific recommendations to bring about changes in various laws and regulations in India. Suggestions have also been laid down for apex institution like NABARD, SIDBI and HUDCO, so as to provide a strong and friendly environment for MFIs to emerge, shine and become sustainable over a period of time.

Scope of Study

The period of post Andhra crisis, can be seen as the first phase of revolution in the field of microfinance in India. Though, RBI has amended guidelines for regulation of MFIs, but merely modification of NBFCs to MFIs cannot bring sustainability for MFIs. In this paper issue of sustainability has been raised in the light of current regulation. This study will lay down the path for future study in respect of sustainability of MFIs and it may helps policy makers to rethink about the current ambit of regulations.

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