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An economic policy and legal analysis of The Micro Finance Institutions (Development & Regulation) Bill, 2011

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Abstract

In response to the Second Micro Finance Crisis in Andhra Pradesh, which took place in October 2010, the Ministry of Finance has pro- posed a new Micro Finance Institutions (Development & Regulation) Bill. This paper undertakes a detailed analysis of the draft Bill in terms of both economic policy and law. This analysis reveals many weak links, including: a lack of clarity on the objectives of the Bill; an insufficient focus on protection of the rights of the micro-borrower; lack of clarity about the definition of thrift; the loss of accountability that comes with multiple regulatory agencies; concerns about the rule of law; and constitutional issues about powers of the Centre versus the State Government.

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30 August, 2011

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1 Introduction

The traditional strategy in India of improving financial inclusion was through intensive government intervention in banking. After a half-century of application of such policies failed to deliver satisfactory results, it has become increasingly clear that this approach has many limitations. In recent years, a fascinating new phenomenon has come about: a dramatic growth of lending to the poor over the last decade through a new channel of for-profit micro finance institutions. These firms tap into equity capital in the formal financial system, and the priority sector lending requirements of Indian banks. They deliver loans to households from the 80th to the 60th decile in the distribution of household income, delivering credit to households where, previously, bank loans were essentially non-existent.

Globally as well as in India, the rise of this new micro finance industry has made some observers uncomfortable because profits were being made by serving the poor. There was discomfort when some of these firms listed with high valuations, such as the the IPO of SKS Microfinance in India. The role of priority sector lending, at the foundation of the business model of these firms, was also a source of criticism.

This period of high growth came to a halt in India, with the Second Micro Finance Crisis in Andhra Pradesh (October to December 2010). Concerns about the violation of the rights of micro-borrowers led to an intervention by the State government[1], which has caused the collapse of the micro finance industry, both in Andhra Pradesh, as well as in the rest of the country.

A lot has been written about the structure, the growth and the problems of the micro-finance industry in India (Kaladhar, 1997; Nair, 2001; Basu and Srivastava, 2005; Chakrabarti, 2005). These developments, in India, mirror the development of this industry worldwide (Arun and Hulme, 2008). Recent work in this field includes Sane and Thomas (2010) and Shankar and Asher (2010).

After the Second Micro Finance Crisis unfolded, the Reserve Bank of India created an expert committee, chaired by Y. H. Malegam, which proposed a regulatory framework primarily for micro-finance firms that are registered as non-banking finance companies, or NBFCs (Malegam, 2011).

Shortly after that, the Department of Financial Services in the Ministry of

[1]See State Government of Andhra Pradesh (2010) for the Ordinance passed by the Andhra Pradesh government.

Finance proposed a 'Micro Finance Institutions (Development & Regulation) Bill, 2011' (Department of Financial Services, Ministry of Finance, 2011). The purpose of this paper is to carefully analyse this draft Bill from a legal and economic policy perspective.

Several areas of concern are identified. The Bill has a lack of clarity of objectives. There is insufficient focus in the Bill on how to address the problem of protecting the rights of the consumer of financial services and products, particularly, the micro-borrower. The Bill shows a lack of clarity on the definition of *thrift* and how it is distinct from *deposit-taking*. This in turn leads to a lack of clarity on how micro finance institution regulation is different from banking regulation. The Bill proposes regulatory responsibility among various entities which leads to a lack of clear responsibility of regulatory responsibilities, and accountability for these. The Bill does not provide sufficient clarity on the amount and sources for financing of regulatory functions. The Bill also raises concerns on issues of rule of law, as well as on the constitutional issues of the powers of the Centre versus the State Government.

The paper is organised as follows: Section 2 is a brief description of the Bill itself. Section 3 lists the broad areas of concerns to be addressed for the Bill to be effective, and presents a short analysis of why these need to be resolved urgently. Sections 4 to 7 offers a more detailed analysis of some of these issues. Section 8 concludes. Finally, the appendix presents a detailed legal review of the Bill.

2 An overview of the Bill

In a nutshell, this Bill views micro finance institutions as 'extended arms of banks and financial services'. It proposes to: (a) Create advisory councils to guide the development of the industry, (b) Place registration and micro-prudential regulatory functions upon the RBI and (c) Create a new redressal mechanism for handling consumer grievances.

The preamble introduces the purpose of the Bill as providing access to financial services for the rural and urban poor and similar disadvantaged sections of the people through *micro finance institutions*. These institutions are proposed as "*extended arms of the banks and financial services*". The Bill also proposes to provide on matters connected to the micro-finance institutions including regulation.

The 35-page Bill covers three broad topics :

1. The creation of advisory councils to guide the development of the proposed industry of micro finance institutions (*Chapters II to Chapter III, from the bottom of page 4 to page 7*),
2. The definition of a framework for registration, micro-prudential regulation, and delegation of powers to the Reserve Bank of India (*Chapters IV to Chapter VI where two Chapters have been numbered IV, from the bottom of page 7 to page 24*, followed by a framework of action to be taken against micro finance institutions under conditions of misdeed or default, and further delegation of powers to the Reserve Bank and various other agencies *Chapter VIII to Chapter X, from page 25 to page 35*).
3. Lastly, matters pertaining to the rights and protection of the customer of the micro-finance institutions through a redressal mechanism (Chapter VII, page 25).

3 Areas of concern

A careful analysis of the Bill reveals broad concerns that need to be urgently resolved. This is based on a clause-by-clause analysis of the Bill from a legal point of view, which is presented in Appendix A. The legal analysis reveals some recurrent themes, which are then culled into the following core concerns:

Missing clarity of objectives The Bill is not motivated by clear objectives. The existing draft Bill does not provide concrete reasons for *why* there is a need to regulate the micro-finance industry, which today largely provides credit services similar to those found in banking. Thus, the question of *What is the problem regulation is trying to solve?* remains unanswered. Problems that the Bill was proposed to resolve, such as issues of consumer protection and problems in the credit processes for micro-borrowers that was identified in the Andhra Pradesh crisis, have not received the focus they merit.

Similarity to Banking There is not enough discussion on the objective of allowing micro-finance companies to carry out functions similar to banking, while giving them the right to collect thrift from micro-savers and micro-borrowers.

Multiple regulators, conflicts and costs The Bill is generally vague and

provides for vast, unchecked and undefined powers to make regulation, which amounts to excessive delegation. It results in the creation of multiple regulators for the same functions, which in turn, creates overlaps in their functioning. The Bill also creates potential conflicts of interest by making the many regulators also *owners* or *investors* in the business of micro-finance. The Bill is not financially sound. A large part of the financial burden on the regulator cannot be borne from the fees collected under this bill.

Appeals process The Bill does not provide an adequate appeals mechanism to either the micro-finance companies or their customers, thereby diluting the standard of rule of law expected from Indian legislation.

Constitutional issues The Bill tries to oust the jurisdiction of the state governments over money lending activities and undermines the federal structure of the Constitution.

4 Missing Clarity on Regulatory Objectives

At a strategic level, all financial regulation can be classified into the areas of consumer protection, prudential regulation or systemic risk regulation. Each piece of financial regulation needs to be associated with the rationale about the market failure that motivates either or all three branches of regulation. An analysis of the micro-finance crisis and collective experience from financial regulation suggests that regulation ought to have following broad focus:

1. Protect the rights of the micro-finance consumer with a primary focus on ensuring quality of financial services distribution.
2. Monitor and supervise the level of disclosure by micro-finance companies to ensure transparency about the risks in the micro-credit portfolios. This would assist funding agencies make informed decisions.
3. Promote the development of the sector by innovations in
   (a) Linkages between customer and micro-finance institution, creating an enabling framework where all types of financial services can reach those who are not financially included.
   (b) Linkages between funding agency and micro-finance institution, creating an enabling framework for all types of formal financial companies to fund micro-finance activities, not just banks.

However, the Bill does not seem predicated on *any* clear objectives. If the aim is to make micro-finance institutions an extended arm of the banking system as the Bill says it ought to be, why not consider giving them Business Correspondent licenses as an approach with a similar goal, but which has the advantage of superior regulatory clarity?

4.1 Missing clarity on Consumer Credit Processes

Consumer credit,[2] in general, and micro-credit, in particular, suffer from some lacunae that require regulatory intervention. These include:

1. Lack of clarity on features of the credit products such as interest rates, and bundled insurance.
2. Over borrowing by consumers.
3. Being denied credit without adequate reason.
4. Lack of clarity on procedures related to early repayment, debt restructuring, bankruptcy, debt collection practices. These are issues are particularly troublesome to resolve in the context of the joint-liability structure under which almost all of the micro-credit business has developed.

There is need for a credit bill to address these areas such that the rules governing the act of *lending* stay the same regardless of the entity, loan amount and purpose of the loan.[3]

The issues listed above are precisely some of the problems that the Microfinance Bill was proposed to solve, and get little attention in the current draft of the Bill. If the Bill needs to justify its existence other than a modified version of Banking regulation, it ought to adequately address all of the above issues.

[2] We define consumer credit as credit taken by individuals and not by companies. The credit may be taken for productive purposes or for consumption.

[3] For example, South Africa established the "National Credit Regulator" to carry out education, research, policy development, registration of industry participants, investigation of complaints, and ensuring enforcement of the National Credit Act. `http://www.ncr.org.za/` Australia has also announced a program of "National Credit Reform" (The Treasury of the Commonwealth of Australia, 2010).

4.2 Missing clarity on Customer Protection

The Bill provides for the RBI to set up as many *Micro-Finance Ombudsmen* as it may deem fit in accordance with a scheme framed under Section 31, 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. There are two problems with this.

First, it is not clear that an Ombudsman model is the correct model to solve individual disputes between the customer and micro-finance agency. This is because the role of the Ombudsman is often to investigate problems from the point of view of the *system* so as to provide a process correction mechanism, and not to provide dispute resolution for *individual complaints*.

Second, even if the Ombudsman serves as a dispute resolution agency, it is not clear from where the Ombudsman gets the power to initiate legal proceedings on the grounds of a complaint. The current Bill does not provide for it. There needs to be greater clarity on the legal framework that will empower the Ombudsman to act as a dispute resolution agency.[4]

5 Similarity to Banking

From reading the whole bill, it can be inferred that micro-finance companies will be allowed to collect deposits, in the form of what has been named *thrift* under the Bill. *Thrift* has been very loosely defined. The Bill does not offer much clarity on how such deposits are different from banking deposits, or how these will be used by the micro-finance companies. This is an especially dangerous trend for a number of reasons:

1. Such a provision effectively makes the micro-finance company, a banking institution.

   Even if thrift deposits are not on *demand deposits*,[5] there are asset liability mismatches that could arise due to difference in maturities of the deposits and loans. Also, the loans in the micro-finance industry carry higher credit risk than that of the normal banking system. This is reflected in the higher interest rate that is charged by the micro-finance

[4] Examples of active financial sector Ombudsmen agencies include the Financial Ombudsman Service in the UK (`http://www.financial-ombudsman.org.uk/`) and the Credit Ombudsman Service in Australia (`http://www.cosl.com.au/`).

[5] These are defined as deposits on which cheques can be written.

companies. If the poor (who the micro-finance industry is supposed to serve) have to put their savings in such high risk activity, the systemic risk is *increased*. Any event which causes a large number of poor debtors to default, will wipe out the savings of a similar (or even larger) number of depositors. The government should clearly decide whether it wishes the poor to finance the micro-finance industry through their savings.

2. A bill which allows financial institutions to carry out *banking-like* activity would create significant regulatory arbitrage. Banks could lose customers if there is higher regulatory burden placed under the Banking Regulation Act. The only solution for the regulator then would be to *equalise* the Banking Regulation Act and the Bill. This would be a very difficult task.

6 Multiple Regulators, Conflicts and Costs

There is a need in the Bill to differentiate the functions of all the regulators involved, which includes the Central Government, the Reserve Bank of India (RBI), National Bank, the Micro-Finance Development Councils and the State Advisory Councils. It seems there has been not much thought as why so many regulators are required in the first place.

In addition, the interaction of the regulators seems to be incorrect. While the RBI is seen as the primary regulator of the industry, the Councils are responsible for advising the Central and State Governments. The National Bank for Agricultural and Rural Development (NABARD) has been provided no primary role in the Bill, but the RBI may *delegate* its powers and responsibility to NABARD if it chooses to. This reflects poor policy where the parent legislation is not even able to identify the regulator to delegate responsibility to. It also creates a situation where, due to overlapping jurisdictions, every regulator will be of the opinion that the function is the duty of the other regulator. This could lead to large regulatory gaps or contradictions.

The Bill also proposes a fund from the fees collected from the micro-finance companies to be used for funding of such institutions through both equity and debt. This, according to the Bill, should be collected by the RBI. The conflicts arising out of owning and regulating the same business is both internationally and domestically well established. When the regulator has commercial interests in a firm it typically loathes to take regulatory action against such companies which may cause loss. In the worse case, the regulator may

design regulations in such a way that companies, in which it invests, enjoys benefits which other companies do not. The Bill undoes several steps the government has taken to remove such conflicts in financial regulation through separation of the regulator and ownership in the public sector banking industry.

There is no provision for an analysis of the financial impact of this bill on the government or the RBI. The complex regulatory structure with three potential regulators and two advisory bodies will be expensive to run. Moreover, the users of micro-finance services are usually poor households who do not have information about, or access to, legal remedies. This would imply that the regulator would have to take a proactive role by employing more staff and carrying out frequent investigations. However, no salaries for staff of such regulators may be paid out of the fees collected. Such fees are predominantly designed to provide for financial assistance and investments in micro-finance companies. This would mean that the micro-finance companies will be able to channel back the fees they paid into their own companies leaving less funds for the regulators to pursue the violators. Such a financial organisation would severely cripple the functioning of the regulator due to shortage of funds. Tax payers would then be left to pay for the costs of regulation, or suffer huge losses due to persistent failures in the micro-finance industry.

7 Appeals and Rule of Law

The provision on criminal actions in the Bill have been very poorly drafted. It makes violation of *every* Section, rule, regulation or orders to be a criminal offence. On the other hand, the consumers have no recourse in civil or criminal courts without the permission of the RBI. The courts to try offences have also been raised to Judicial Magistrate, first class. This creates a situation where the end consumers have very few legal remedies *if the regulator does not act*. This is against the general principle that a person who has been harmed by an action has the right to approach the court to get justice. There is a need to empower the consumers in the micro-finance industry, not take away their right to approach courts.

The conditions of appeals for the micro-finance companies have been severely limited as well. There is no clear route from the regulator to the writ courts. Moreover, the first appellate authority is the Central Government, which is an executive wing and does not have judicial expertise. The Bill does not provide for how the Central Government will organise the appellate mechanism.

8 Conclusion

Micro-finance in India has faced a crisis in Andhra Pradesh. At this stage, the policy response should involve a careful diagnosis of the *sources* of this crisis, which should then lead to a commensurate response to resolve problems. This can be done using the tools of financial regulation, which are:

1. Consumer protection
2. Prudential regulation
3. Systemic risk regulation.

The complaints against micro-finance institutions in India revolve around issues of predatory lending and unfair debt collection practices. Additional problems include high interest rates charged on, and mis-selling of, micro credit products.

Any policy response, such as regulation, should therefore concentrate first on the protection of the *borrower* from the *distribution* practices of the micro-finance institutions, rather than focus on prudential regulation, which has been the focus of most of the discussion in India.

Regulation also has an important role to play in facilitating funds flow to the micro-finance lending business. Policy needs to facilitate information sharing both between financial institutions and micro-finance institutions, and between micro-finance institutions themselves, about borrower quality, so that decisions are made on a base of trust that is not vulnerable to the vagaries of public opinion or of political economy.

If the broad aim of the Bill is to allow micro-finance institutions to act as *banks*, then there needs to be greater debate on the implications of this on both institutional and governance structures required of any deposit-taking institutions, and on lender and borrower protection, as poor customers will simultaneously be lenders to and borrowers from the micro-finance institutions.

In addition, the Bill can be strengthened through a careful examination rooted in the principles of financial economics, principles of public administration and principles of rule of law.

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A Detailed legal review of the Bill

This section of the document analyses specific provisions by quoting parts from the Bill. The objective is to analyse the Bill from a legal perspective, so as to identify areas which could create problems of litigation in the future. The following are a list of specific aspects of the Bill which has to be resolved explicitly.

Preamble *... growth and development of micro finance institutions as extended arms of the banks ...*

It is unclear whether this implies that Micro-Finance Institutions (MFIs) will be restricted to get funds only from banks and other financial institutes. This raises the following questions: Is it possible for an MFI to use equity funding (both private and public) for business? Does this imply that MFIs will also be owned by banks and financial institutions, and therefore, cannot be considered a separate industry? This is contrary to the real-world experience where micro-finance has grown to be an industry of its own.

Preamble *... financial services to the poor households and their micro enterprises as an extended arm of the banking system;*

The essential feature of a banking system is in taking deposits and making advances against those deposits. Banking laws prohibit any other business from carry out the business of banking. The sentence above implies that micro-finance will act as an *extended arm of the banking system.* Therefore, does the above definition imply that MFIs will carry out the essential feature of banking system?

This is a problematic issue because this would end up creating a parallel banking industry without the explicit protection and regulatory burden of the normal banking industry. This has the potential of creating the risk of asset liability mismatches within the micro-finance industry. It would also cause significant damage to the banking industry due to regulatory arbitrage.

Preamble *thereby to facilitate universal access to integrated financial services for the unbanked population.*

If the MFI is to provide *all* financial services, it should be explicitly regulated for all such financial services. This contradicts the previous statement that it is an extended arm of the banking system.

Further, it raises the following questions: Does the above imply that an MFI is *required* to provide all financial services? What about hybrid services or non-financial services? For example, can an MFI provide a *gold loan*, or reverse mortgage, or some financial service not otherwise provided to *rich* who are not customers of the MFI? Can the MFI provide products or services like fertiliser or health on credit? Would such services be prohibited because they are not what is considered financial services *today*?

If these questions are not explicitly resolved, the Bill could lead to stagnation in the innovation by the micro-finance industry, rather than facilitate development.

Section 2.(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;*

The term *financial assistance* has multiple associated problems:

1. *Financial assistance* implies a charitable nature in the business of micro-finance. This militates against the possibility of micro-finance companies which are for-profit. This also implies that the consumers of micro-finance are those who require *assistance* rather than become viable credit customers.

2. The definition of the term does not, in any way, clarify the term or provide any legal test of what is, and what is not, financial assistance. *Loan* and *advance* imply a commercial transaction. While *loan* is financial in nature, *advance* may not be.

   For example, organisations may provide *money in advance* for services or products at a later date. The term *grant* denotes an endowment from which no return is expected. Does this then imply that organisations providing charity would also come under the ambit of this bill? Many a number of times, *guarantee* is provided with our without consideration. Guarantees may be provided out of long standing business relationship as well.

3. The definition provides that the *loan*, *advance*, *grant* may be in cash or *in kind*. This could cover all non financial transactions as well. Even repayments in kind would also be covered in this definition.

   For example, a shop providing fertiliser for payment at a later time would be considered a financial assistance.

4. This definition in its ambit covers almost all transactions, where either a payment or delivery of service or goods is made at different points of time.

   For example, a *forwards contract* would also be covered under this definition. In fact, there is almost no transaction imaginable which is not covered under this definition.

   The objective of a legal definition should be to provide certainty. It should clearly define the boundaries of the transaction it seeks to cover thereby informing all what are the actions it does not seek to cover. Definitions like these do not provide any information at all for the lawyer, judge, and endows the regulator with unlimited/ absolute power.

Section 2.(e) *... the cost of funds raised and other operational costs incurred by the micro finance institution ...*

Costs of funds raised is easy to determine if the funds are raised through debt. It is very difficult to determine in the case of equity. When micro-finance business is funded through equity (from both private and public sources of equity), it will be nearly impossible to determine. Private equity investors may have high expectations on returns which may not be unjustified in the risky nature of the advances made by MFIs.

Section 2.(f),(g) Definition of *micro finance institution* and *Micro finance services.*

The definition of *micro-finance institution* is dependent on the definition of *micro-finance services.* This would not have been a problem if *micro-finance services* had an unambiguous definition, which is not the case. *Micro-finance services* have been defined as providing services with small value. The problem with this definition is that it does not exclude a normal financial services company providing small ticket services.

For example, if the Life Insurance Corporation of India (LIC) were to launch a small ticket insurance service, a reading of the two aforementioned definitions would make LIC an MFI.

Section 2.(g) *remittance of funds*

The entry *remittance of funds* is not readily differentiable from *transfer of funds.* The activity of funds transfer are regulated under the Payments and Settlement Systems Act of 2007. This could have two

probable outcomes for the micro-finance industry: (a) The MFI would fall between two regulators and the regulatory contradictions would make the business unviable, or (b) The MFI would enjoy regulatory arbitrage, thereby undermining the objectives of the Payments and Settlement Systems Act.

Section 2.(o) *Systemically important micro finance institution*

The definition of *systemically important micro-finance institution* has been left entirely to the regulator. There is no direction as to what are the criteria for a systemically important MFI can be. There is no process mentioned on the adjudication of such MFIs. There is no objective for regulation of systemically important MFIs.

Such a system would be prone to creating extra regulatory burden on such MFIs making them non-competitive.

Section2.(p) *from members of self-help groups or any other group of individuals by whatever name called*

There is a contradiction between the definition of *thrift* and the definition of *micro-finance services* under section 2(g). The definition under Section 2(g) refers to the collection of thrift from *individuals or groups*, implying that thrift could be collected from a single person.

The definition under Section 2(p) of *thrift*, on the other hand, states that *thrift* is deposit collected from *members of self-help groups or any other group of individuals.* This implies that thrift collection can be done *only* if the contributor is a member of a self-help group. This raises the following question: Can thrift can be collected from an individual or not?

Section 3 *... growth and development of the micro finance sector and micro finance institutions, to promote financial inclusion.*

There is no definition of the term *financial inclusion.* This is an important lacunae in the law. If the objective of the Council is based on an undefined term, there is high probability that the Council will not meet the expectations of the law.

Section 5.(i) *adoption of any innovations and use of technology in providing micro finance services;*

The above implies that it will be the job of the Council to develop new technologies and innovations, instead of allowing the industry to

do so. This will be a strong demotivating factor for the industry to introduce new products and services, since these will not be allowed to be operationalised till the Council deems it fit. On the other hand, the Council itself gains little from the adoption of innovation, particularly if they have to first understand the implicit risk and rewards of these innovations. Typically, the Council will have little incentive to drive innovations, and this will slow down the development of the industry.

This provision is also contrary to what is standard in most other industries where the innovation and technology comes from within the industry, and the role of the government is limited to ensuring that such innovation and technology is not harmful.

Section 10. *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.*

The lack of clarity in the definition of micro-finance services makes the licensing requirements vague. Moreover, the term MFI is redundant as it does not explain the nature of the entities which require licensing. If this is left open to interpretation, almost any entity providing financial services would be enumerated within this definition.

Section 11.(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.*

The vague definition of micro-finance services also adds ambiguity to this provision. Since no definition of micro-credit has been made, technically all Non-Banking Financial Companies (NBFCs) providing credit facilities could be required to registered.

For example, if NBFCs provide credit worth Rs.20,000 per customer, does such an NBFC have to register as an MFI? This act does not inform NBFCs, with any certainty, whether it applies to them or not. This regulatory vagueness will cause considerable disruption in both the MFI and the NBFC industry.

Section 12.(1)(b) *the applicant is engaged in the promotion and development of financial inclusion by providing micro finance*

services;

This provision is in contradiction to Section 11.(1). While Section 11.(1) requires an MFI to apply before starting business, Section 12.(1)(b) requires the company to be engaged in providing micro-finance services. If the company is already engaged in micro-finance services, then it is in violation of section 11.(1).

Secondly, the term promotion and development of financial inclusion is not very clear. It must be accepted that most for-profit MFIs have a business focus in finding profitable customers who are risky, but willing to pay higher rates for financial services, rather than in promoting financial inclusion. It is in the objective function of the government to promote financial inclusion. We must acknowledge and accept that financial inclusion is a positive by-product of the action of the for-profit MFIs.

Section 15.(1) *... which becomes systemically important institutions 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,*

This provision requires that an MFI which is a co-operative, must turn itself into a company on being declared systemically important. Such a provision regulates the behaviour of co-operatives. Co-operatives are a subject of state regulation under the Constitution. Requiring a co-operative to change its character impinges on the federal structure of the Constitution. Therefore this provision will not be applicable to MFIs structured as co-operatives.

The term *systemically* and *systematically* has been used interchangeably in the section. There is no definition of the word systematically.

Section 16.(1) *Appeal against certain cases*

The right of an MFI to appeal against decisions, regarding the application for a certificate of registration or the cancellation of the certificate, has been extremely curtailed. Only the decision of denial of the certificate, or an order to close down the business, can be appealed against. For example, no MFI can appeal against a decision by the RBI declaring it to be systemically important.

Such limited right of appeal is not conducive to rule of law. In comparison, any entity which is aggrieved by any order of the Securities

and Exchanges Board of India (SEBI) has the right to appeal to the Securities Appellate Tribunal.

Section 17.(1) *Obligation to create reserve fund*

There is no explanation in the Bill as to *why* a reserve fund ought to be created by MFIs. There is no explanation for the purposes for which such fund will be used. Even a broad defintion of the use of these reserve funds has not been specified.

Section 21.(3) *The expenses of, or incidental to, the audit specified in the order made by the Reserve Bank under Clause (a) of section 20 shall be borne by the micro finance institution concerned.*

This provision raises the following question: When the special auditors report shows no difference from the normal auditing of the MFI, should the MFI be liable to pay for the audit?

There is no doubt that when the auditor report unearths facts which have been hidden by the MFI, the MFI should not only pay for the report but be liable for other criminal or civil penalties. However, this provision can be used to victimise a MFI. When the report shows that the MFI had been honest, it should be the liability of the RBI to pay for such audits. This will be a more fair distribution of the liability to pay for special audits.

Section 23 *... for the purpose of promoting financial of Reserve inclusion.*
(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) ... model codes for conduct of business of micro finance institutions

If it is the duty of the RBI to formulate and facilitate the growth of the micro-finance industry for the purpose of promoting financial inclusion, then why is the Micro Finance Development Council (proposed in Chapter II) required to advise the Central Government in matters of policy for promoting financial inclusion, as proposed in Section 5.(iv)? If the RBI will formulate policy for financial inclusion, then the Council

should advise the RBI, and not the Central Government.

On the other hand, if the Central Government formulates policy for financial inclusion, and the RBI is an implementing body, then the RBI ought not to have power to formulate policy.

If both entities (the RBI and the Central Government) formulate policies, contradictions will be inevitable. From a reading of Section 23 and Section 5, there seems to be significant overlap between the functions of the RBI and the Central Government with the Council. This overlap can have four possible outcomes:

1. Either the policy formulation by the Central Government with the Council, or that of the Reserve Bank policy, will become redundant. One entity will have a statutory mandate but not any work, which will lead to a waste of resources.
2. Each body will think that the formulation of policy is the work of the other, and will continually shift responsibility.
3. Both bodies will form the same policy, thus will lead to the duplication of work without any advantages.
4. Both bodies will form different policies, which will then lead to contradictions and disputes, and will leave the micro-finance industry with contradictory signals on the development in the sector.

Section 24.(1) *... 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 ... shall be bound to follow the policy so determined and the directions so issued.*

Such a system of provisioning and risk weights are applicable to banks, which take deposits and make advances against them, with the clear objective to protect the depositors of the bank. It is in the interest of banks to earn maximum margins from loans, excessive levels of margins also increase the risk of repayment failure. This puts the depositors money at risk. Risk weights and provisioning norms are put in place to counterbalance this behaviour of banks.

Since almost no MFI makes advanaces against deposits, it is not clear what role of such norms plays. If any MFI is taking deposits against

which it makes loans, then it should ideally register itself under the banking regulation laws. If this Bill allows MFIs to collect deposits and make advances against them, then it will become a parallel Banking Regulation Act. This would lead to problems of regulatory arbitrage between banks and MFIs, which would harm both the micro-finance and the banking industry.

Section 24.(2)(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;*

This is in contradiction with provisions stated in Sections 5 and 23. Section 5 implies that the Central Government will formulate policies for grievance redressal while Section 23 implies such policy formulation and implementation will be formulated by the RBI for codes of conduct (Section 23.(b)). The present provision implies that Self-Regulatory Organisations (SROs) of MFIs will provide for code of conduct. There is an urgent need to clarify *who* will develop the code of conduct and mechanisms to redress grievances that have ben proposed in the Bill.

Section 25.(1) *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.*

The specification of margin by the RBI may have significant competition law issues. The above statement would standardise the returns and rates that an MFI may charge, irrespective of their source of funding. This would encourage collusive behaviour among MFIs.

Section 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.*

If an MFI is not taking deposits, or has any dues to any creditor, it is not obvious why shutting down of the business should require regulatory approval. It is not clear whether this section applies only to the business of micro-finance, or to other services carried out by an MFI, as well. An MFI could provide non-financial services like sale of fertilisers or farming

implements. There seems to be no legal reason to require permission to close down such services.

More importantly, the Bill clearly extends its ambit outside its stated objective to regulate the micro-finance industry, by controlling other services.

Section 28.(1) *... may file an application for winding up or any other application by whatever name called,*

This provision raises the following question: Can the RBI file an application for amalgamation or compromise of the MFI? This provision would give the RBI wider powers than originally allowed under bankruptcy and winding-up proceedings.

Section 30.(1)(a) *all Government grants received and fees payable under this Act;*

If all the fees payable under this Bill is given to the Micro-Finance Development Fund, then there will be an additional burden on the Central Government to fund the Micro-finance Development Council and the State Advisory Councils. The cost of employing persons inside the RBI to monitor MFIs, draft regulations, scrutinise applications, carry out investigations, defend appeals, set up an ombudsman scheme, etc., will have to be borne by the RBI.

By putting all the fees collected under this Act into the Development Fund, the financial costs of the Central Government and the RBI to regulate the industry will have to be collected from general taxes, which is unfair to the entire nation. Further, such a move could result in one of two outcomes:

1. The Central Government and the RBI will have to expend their own resources (from other sources) to subsidise these activities of regulation of the micro-finance industry.
2. These activities will remain underfunded and not fully carried out.

Section 30.(3)(a,c) *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;*
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;

This provision would create many conflicts of interest. It is a well-known principle of public administration that the owner of a business cannot be an effective regulator of the business. If the RBI makes advances to the MFIs through the Micro-Finance Development Fund, it will end up being an investor in some MFIs. This would create problems because the interests of a manager/investor is to maximise profits, which contradicts the interests of the regulator.

A large number of steps have been taken by the RBI to divest its ownership of public sector banks to remove these conflicts of interest. Today, the RBI makes no advances or assistance to the public sector banks. This is seen as a cornerstone of good regulatory policy where the regulator treats government and private owned entities similarly. If this development is undone, it would be detrimental to the development of the financial sector in India.

Section 30.(3)(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 ...*

A clear implication of this Bill is that the role of the regulators will increase greatly. The RBI will have to appoint officers and other persons to carry out functions mandated under the Bill. It is patently unfair to not allow such expenses to be recouped from the fees collected under this Bill.

This is also contrary to the structure and processes at other Indian financial regulators. Both the SEBI and the Insurance Regulatory and Development Authority (IRDA) are funded by fees that they collect, to cover their costs, including salaries and other expenses.

Section 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,*

Section 5 stated that the Central Government, with the advice of the Council, will form policies for redressing grievances. Later in Section 24.(h), this power was granted to SROs of MFIs recognised by the RBI. Here, the policy is being laid down in the form of an Ombudsman

mechanism. This would make the previous statements redundant as any other policy, which is not the Ombudsman mechanism, would be contrary to the law, or at least not as enforceable as the Ombudsman system envisioned in the Bill and sanctioned by the Parliament. The Bill should choose a single mechanism, rather than provide for three potentially contradictory mechanisms.

Section 32.(1) *(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 ... or with imprisonment for a term not exceeding two years or with both.*

This provision raises the question of whether all provisions of the Bill should be considered to have criminal consequences.

For example, if the Member of the Development or Advisory Councils exceeds his term as specified in Section 6 and 9, should they be liable to be imprisoned for two years? Moreover, whether an action is criminal or not, is usually laid down by Parliament alone. This is because criminal liabilities takes away the fundamental rights of a person. Therefore, all actions which are criminal are mentioned in the parent legislation. Regulatory authorities do not have the right to imprison persons solely for the violation of regulations. The present provision makes violations of orders and directions, a criminal offence, with consequent imprisonment. The government should reconsider limiting criminal violations to specified sections of the Bill.

Section 32.(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*

This provision seems to be a repetition of Section 32.(1). It is also not clear what provisions of this Bill provide for the Central Government to issue orders to a person. More importantly, the violation of the orders of an Ombudsman generally harms the consumer/ client. Yet, because the fine will be collected by the Central Government, a customer who follows up on a case with an ombudsman will be worse off. While a non-compliance fine may force the MFI to act, there is no system defined for compensation, or transfer of fines, to the customer who is actually

harmed under the regulations.

Section 33 *... with further fine, which may extend to ten thousand rupees for everyday after the first, during which the contravention or default continues ...*

It is unclear how wilfully misleading the RBI can be a continuing offence. Should the fine be calculated from the time that such misleading was started till it is uncovered? It would be very difficult to prosecute for such offences, without a clear explanation of how such offences are considered to be continuing.

Section 37.(1) *No court shall take cognizance of any offence punishable under this Act or any rules or regulations made there under, save on a complaint made by an officer or other person authorised by the Reserve Bank.*

Section 37.(1) is in apparent conflict with 32.(3) which makes all offences for *thrift* to be cognisable. It is not clear whether the consumer may approach the course for the violation of *thrift*. It must be pointed out that any violation of acceptance, or payment, of thrift affects depositors to a large extent. It will be depositors who will be the first to be informed of such violation. If such depositors are denied the right to make criminal complaints, criminal investigation could be delayed. It is also unfair to not allow depositors to prosecute for criminal acts since they are the ones who lose their savings under such fraud.

Section 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.*

This provision goes against the principle of *Delegata potestas non potest delegari* which means that a responsibility delegated to one entity should not be further delegated by that entity.

It is optimal that the parent legislation (in this case, the Bill) identify the body which will carry out the regulatory functions. It will become very difficult for the government to hold a regulator responsible for performance or lapses, if further delegation is made. It also creates confusion as to whether the National Bank should follow the parent legislation or the instruction from the RBI.

Secondly, the National Bank itself is a major player in the micro-lending industry through its sponsored institutions. This would create the same problem of the owner of the business being the regulator of the business as pointed out in the commentary for Section 30.(c)

Section 39 *In the event of a micro finance institution making any default in repayment of thrift to any of its members or eligible clients who had made a contribution to thrift, all members or eligible clients of such micro finance institution shall have a first charge over the specified unencumbered securities referred to in sub-section (3) of section 18.*

Section 18 does not have any subsections. This probably refers to Section 17. However, it is not clear whether this overrules the general and special bankruptcy laws of the nation.

Section 41 *The Central Government may, on being satisfied that exempt. 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.*

This is, in effect, a Henry VIII clause. This effectively gives power to the Central Government to modify this Act with respect to certain entities. It has the potential to be abused to create exceptions for government-owned entities. This would not only make the field of micro-finance uneven for participants, but could also lead to serious regulatory lapses. Moreover, such a clause makes the Central Government superior to the expression of Parliament, which is against the concept of democracy.

Section 42 *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.*

The present constitutional structure in India does not allow a central legislation to override matters of state legislation. This exception may be given to banks, which are a part of the central legislative matters. If the nature of the business carried out by micro-finance companies is

essentially money lending, then the state legislation regarding money lending will apply. Such overriding of federal structure cannot be done in a central legislation and, more so, in an explanation. The constitutionality of such provisions are highly suspect. It is dangerous to attempt to subvert the constitutional separation of subjects.

Section 44.(2)(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;*

This provision is confusing because the Bill mandates each MFI to create a reserve fund in Section 17, where the reserve fund is regulated by the RBI. In the current provision, the power to regulate the reserve fund is being given to the Central Government. This raises the question of whether this is a separate fund or the same fund as the one mentioned in Section 17? If the latter is true, then this is another instance of regulatory overlap. It is important that the miscellaneous powers do not overlap in the Bill.

Section 44.(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.*

The power of the MFIs to accept *thrift* should be stated in the part regarding *thrift*, and such provision should overrule the powers of other Acts.