



RESEARCH ARTICLE

WHISTLE BLOWER FOR GREATER COMMON GOOD

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ABSTRACT

Microfinance has assumed a seminal importance over the years. It is being considered a major avenue in socio-economic development and also as a tool of financial inclusion. In India, however, steep rates of interest in the field, multiple borrowing by the clients to repay the loans and a spree of suicides by the alleged defaulters have put Microfinance in a bind. Consequently there is a soaring demand for regulating the field. The article traces the efforts of regulating the field of Microfinance in India. In course of discussion the article conjures up a debate that whether regulating the field will ensure greater common good.

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INTRODUCTION

Smugness overwhelms and absolute smugness overwhelms absolutely. Perhaps this describes the present desolate situation of microfinance and micro-credit in India. No doubt for a certain period the industry was in an expanding spree! The authorities were content that the sector has taken care of itself and harping on *laissez faire* it maintained a safe and considerable distance. However certain recent developments in this field have blown off the lead and the worms are out of the can! Their dubious methods of recovery, exorbitant rate of interest coupled with a tendency of multiple lending by the borrowers to service the instalments gave MFIs a bad name. A number of suicides occurring in Karnataka and Andhra Pradesh which are being linked with micro- financing also contributed to the entire ruckus. The state responded in a fire fighting mode. A couple of committees came up. An ordinance was promulgated by the Andhra Pradesh Government to apparently 'rein in' the delinquents. Despite the steps, point however remains as to whether the deep seated maladies of the sector were addressed.

Origin of microfinance and a shift in paradigm

Despite their fundamental difference, microfinance and micro-credit may convey the same meaning to non-initiated. Towing the definition offered by 1997 Micro-Credit Summit of Washington, D. C. micro-credit denotes "extending small loans to poor people for self-employment projects that generate income, allowing them to care for themselves and their families"(in Indian context either directly or through SHGs and JLGs). Microfinance on the other hand signifies

"provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas enabling them to raise their income levels and improve living standards"... ('Task Force on Supportive and Regulatory Framework for Micro-Finance in India' 1999).

Culling from international literature empirical features of Micro-credit are: ¹

- Quantum of loans is small,
- No collateral required,
- Rural and urban poor are the major borrowers.
- Ideally loans are used for income-generation through market-based self-employment. Their usage in consumption is also found in abundance
- Loans are administered through borrower groups.
- Owing to NGOs' controlling disbursement as well the basic terms and conditions for sanction, they sometimes become private transaction.

Darling's aphoristic statement that "the Indian peasant is born in debt, lives in debt and dies in debt"; (1925)² still holds good. Only the ambit has been extended; it now includes all the poor of the country. While the effort of extending collateral free loan to poor can be traced back to 1720 in

¹ *Financial Liberalisation And Rural Banking in India*-V.K. Ramachandran & Madhura Swaminathan, Paper presented at 'International Conference on 'The Agrarian Constraint and Poverty Reduction' 2004.

² *The Punjab Peasant in Prosperity and Debt* M. L. Darling... (Oxford University Press). 1925

Dublin³, in India it was systematically started by *Shri Mahila SEWA Sahakari Bank* in 1974. The concept shot into prominence in the post 1991 period during liberalization of the Indian economy. Despite nationalization, formal banking system faltered in catering to the credit needs of income-poor, vulnerable and disadvantaged section of rural area. Non-viability of loaning small amount and that too at regular intervals and below par recovery characterized banks' efforts. Consequently NGO led micro-credit leapt into prominence.

1. It was felt that the NGOs could handle credit requirement of vulnerable section of the community in an imaginative and sustainable manner;
2. externalization/outsourcing of a major portion of the credit processing will reduce the transaction cost, and;
3. NGOs are expected to perform better than formal sector credit institutions in respect of the recovery of loans⁴.

Dichotomy was inbuilt in the approach itself. Field data amply suggest that NGOs can scarcely take advantage of economies of scale and an increase in activity resulted in proportional spike in administrative cost. Consequently the cost of fund escalates. NGO led MFIs try to offload this increase either by charging usurious interest rate (a simple calculation is provided in table-1) or by accepting fund from the donor agencies. NGO led MFIs' zero tolerance to default and utter lack of any intra-system coping mechanism in case of stressed repayment aggravates the issue. State of affairs turns further grim as first generation loanee were the end users.

Table-1⁵

Components of Interest rate	Weightage Charged in %
Salary and incentives	6.4
Overheads	4
Cost of fund	8.5
Loan-loss-Provisioning	1.5
Corporate tax	2.8
Profit	5.1
Interest rate	28.3 (In Andhra Pradesh the rate of interest is 24.5 to 26.69)

Regulating the field

Consequently the field needs regulator more so as micro-financing is being considered a method for ever elusive financial inclusion for the poor. This will also arrest the somewhat dubious tendency of the MFIs to make their pile and withdraw! Statutory regulations are imperative since a) MFIs are trying to enlarge their service-range by accepting deposits while at the same time are dealing with financially illiterate first generation users, b) low-income groups unable to bear the risks are the basic set of clients of MFIs and there is a need for protecting them as the implicit contingent liabilities are on the state c) MFIs hardly make provisions for

³ *Ruffled Feathers*-P.Swami,Meenu,N.Choksey-Business India Nov 14,2010

⁴ *Does Informal Credit Provide Security?Rural Banking Policy in India*V. K. Ramachandran & Madhura Swaminathan International Labour Office, Geneva October 2001

⁵ *Ibid*-P.Swami,Meenu,N.Choksey-Business India Nov 14,2010

delinquent loans. Rather they go in for aggressive collections which need to be tempered and finally d) all types of MFIs should be given a level playing field. Throughout the world, the concept of regulating MFI sector is gradually gaining currency. This can be construed as a reaction to deviant demeanour exhibited by some organisation as well due to their steady acceptance as instruments against financial apartheid. Also this is a way to re-inject the social objectives into microfinance transactions. Despite the fact that regulations may sometimes become self defeating (*viz*, any cap in interest rate may dis-incentivise their outreach to difficult terrain) the plus points are many⁶.

- i. Regulation protects the interest of the depositors as well guides the MFIs;
- ii. makes prudential norms, internal control system and intrinsic governance of funds effective. Also ensures appropriate portfolio management.
- iii. provides sufficient information for risk-management by the MFIs;
- iv. ensures promoters systemic stability thereby sustaining public confidence in MFIs; this is a high priority zone as the sector often acquires political overtone,
- v. paves the path of precise, immaculate and seamless intervention during stressful situation
- vi. penalises the delinquents
- vii. plugs the knowledge gaps and provides for practical inputs for smooth operation and improvement of the MFIs;
- viii. increases networking with other financial organisations
- ix. and finally, caters to orderly economic growth and development.

Regulations however should be customized to national circumstances, needs to be activity oriented and proportionate to the expected benefits. Regulations become the basic enabling factor in adoption of wider spectrum and perspectives of micro-financial activities. It also enhances access of the marginal groups to finance. Since MFIs are managed by board members having no stake in the overall equity of the company, the management has an incentive to abuse its power for self-fulfilling objective either individually or collectively. It may sound rather sneering, but regulations can rein in this trend. Nobel Laureate Muhammad Yunus, however, sounds cautious.

"The existing regulations are designed with commercial banking in mind, but microfinance requires a dedicated regulator and a relevant set of rules. Commercial banking is like a super tanker whereas microfinance is like a dinghy boat with which you can reach small corners. If you design a dinghy boat with the architecture of a super tanker, it is sure to fail."

⁶ *Microfinance Sector in India - Developing a supportive policy and regulatory framework and environment - Position and Perspectives* - Biswa Bandhu Mohanty, Paper presented in International Conference of Microfinance Regulation- Dhaka, Bangladesh, March 2010. Full text available at [/www.mra.gov.bd/conference/index.php?option=com_content&view=article&id=122:international-conference-on-microfinance-regulations&catid=1:latest-news](http://www.mra.gov.bd/conference/index.php?option=com_content&view=article&id=122:international-conference-on-microfinance-regulations&catid=1:latest-news).

Regulating the field- story worldwide

An initial attempt of regulation was made in Latin America and they are basically of two types.

1) **Self Regulation and market discipline** requires MFIs to follow and adopt internal control, good governance and proper disclosure systems. Adoption of these three tenets automatically subjects them to the rules of the market where non-performers are weeded out.

2) **Regulation through External Bodies** - Bringing the MFIs within a regulatory system espoused by external agencies is also an alternative. In this case either a *Government Regulatory Authority* is established or the *Supervisory role is outsourced*. To exercise a sensible control over the MFIs a judicious mixture of self regulation with that of external control is warranted. In Bangladesh the MFIs are basically self-regulated and the reporting requirements of all these MFIs to the Bangladesh Bank have been only for statistical purposes, and not for any prudential regulation. Contrary to this Nepal chose to introduce formal supervision and regulation of MFIs through Financial Intermediary Societies Act (FISA) of 1998 thereby empowering the Nepal Rashtira Bank (NRB) to be the licensing, regulatory and monitoring agency for MFIs⁷

Regulating the field- story in India

A caveat will be in order. In India efforts of regulation has always been a knee jerk response and any exercise in this regard draws heavily from recommendations of two committees namely; report of the 'Committee on Financial Inclusion' 2008 (customarily called Rangarajan Committee)⁸ and a Sub-Committee of Board of Directors of Reserve Bank of India, constituted in October 2010, chaired by Shri Y H Malegam a senior member of the Reserve Bank's Central Board of Directors (customarily called Malegam Committee)⁹. Rangarajan Committee made some bold recommendations for the sector as a whole. The committee favoured restricted entry of foreign equity and venture capital funds in the sector along with tax concessions as incentives to MFIs operating in a hostile terrain. Distinct category MF-NBFC, the committee held, should be created to act as Business Correspondents of banks for providing savings and remittance services. Definitely this calls for enhanced operational efficiency involving ICAI accounting standards and proactive disclosure of norms and rules of business under the watchful eyes of RBI to be delegated later to NABARD. The committee sagaciously felt that acceptable interest rate can only be derived after a 'due diligence', lender's discipline and acceptable modes of recovery is worked out considering MFIs risk premium, operating cost etc by the lending banks.

Comparison reveals contrasts. Malegam committee was more conservative and wee bit cautious in their approach. The basic ground reality involving number of suicides and a popular

aversion to the functioning of the sector can be attributed to this. Malegam Committee spoke in favour of

1. Creation of a separate category of NBFC-MFI observing a specified 'Code of Corporate Governance' aimed to provide short-term, unsecured small amount loans predominantly to low-income borrowers for income-generating activities (75% of the loans should be for this purpose), with comparatively more frequent repayment schedules.
2. Banks' lending to these MFIs will qualify for priority sector lending.
3. A "margin cap" of 10 per cent for MFIs having a loan portfolio of Rs. 100 crore and of 12 per cent for smaller MFIs and a cap of 24% for interest on individual loans was suggested. It also proposed that, in the interest of transparency, a MFI can only levy three charges, namely, (a) processing fee (b) interest and (c) insurance charge after declaring the rates in a proper and transparent manner.
4. Members only of Self-Help Group (SHG) or Joint Liability Group (JLG) are entitled to borrow and that too from any two MFIs .
5. A minimum period of moratorium will hyphen disbursement of loan and the commencement of its recovery. The tenure of the loan must be amount specific.
6. Coercive methods of recovery should be avoided; 'Customer Protection Code' prepared by RBI, Grievance Redressal procedure, Credit Information Bureau, and a system of Ombudsman should be in place. MFIs, industry associations, banks and the Reserve Bank will monitor the performance of the sector.

Comparing the observations of two committees, it is apparent that both the committees are in favour of a regulator, welcomes operational efficiency, opposed coercive and abusive tactics and preferred transparency. They differed in terms of role identification of MFIs and in capping the interest rate. Malegam committee considered MFIs to be lending institutions only and neither considered them as provider of financial services nor has given any direction as to whether they can collect deposits from the poor. The committee's cautious approach is evident through their proposition that the MFIs will lend only to SHGs who in turn will deal with the individuals. Furthermore the suggestion that the MFIs need to collect intricate information about the 'deserving poor' prior to lending becomes an uphill task in view of ceaseless migration of the poor. Malegam committee also suggested a cap in the interest rate of MFIs. Several states like Tamil Nadu, Andhra Pradesh, Karnataka, Kerala, Bihar, Assam and West Bengal were quite upbeat with these recommendations. They want its quick implementation. In fact general mood is that RBI or NABARD should be the sector regulator, backed up by a central law with an imbued provision of state-supervision. The opinion of the industry and other similar bodies are still awaited.

a) Internal Control

In 2006 Andhra Pradesh saw people aghast with MFIs of Krishna district. Self-regulatory codes were drafted by *Sa-Dhan*, an organization of MFIs, to defuse the situation. To encourage 'progressive, sustainable and client-centric' MFIs, tenets of self-regulation involving integrity (no client-

⁷ *Ibid*- Biswa Bandhu Mohanty

⁸ Overview of the report is available at

www.nabard.org/financial_inclusion.asp. For full text www.msmentor.in/.../Rangarajan%20Committee%20report%20on%20Financial%20Inclusion.pdf (visited on 5/5/2011)

⁹ Recommendations of Y.H. Malegam committee available at www.sebi.gov.in/commreport/maligamdip.pdf (both visited on 5/5/2011)

poaching, and operation through dedicated and oriented staffs), transparency (proactive disclosure of norms and rates of interest) and fair-practices (cap on amount of loan, no arm-twisting for recovery, ICAI professed accounting procedure and method of grievance handling) were floated and adopted by large number of MFIs on 18/1/2007. This pledge was renewed in their 12th Annual General Meeting on 30/4/2010, probably again as a reaction to the 2010 catastrophe. This debacle prompted Microfinance Institutions Network (MFIN), another organization of MFIs; set up in October 2009 to come up with another conduct code in 2010 focusing on identical parameters.¹⁰ The presence of two sets of self-regulations (*Sa-Dhan* and *MFIN*) as well adopting the same set twice (*Sa-Dhan*'s regulation was adopted in 2007 and again in 2010) probably underlines the inherent fickleness of the system. May be, it also provides an escape hatch to the delinquent MFIs who shift from one lane to another and scarcely follows either!

b) External agency-Governmental Control

Happenings in 2006 were able to elicit another response. The government drafted the 'Micro Financial Sector (Development and Regulation) Bill, 2007'¹¹ basically to regulate and re-engineer the field. The bill was referred to the 'Standing Committee' by the Union Legislature on 20/3/2007. The bill is yet to be passed. The bill *inter alia* proposes to regulate, and develop the 'Micro Finance Organisations' (MFO) registered under Societies' Registration Act (1860), Indian Trust Act (1982) and Multi Purpose Co-Operative Societies' Act (2002) through NABARD. The sector will be guided by Microfinance Development Council (MFDC) consisting of *crème de la crème* officials of RBI, SIDBI, NABARD, Indian Government and National Housing Bank. It envisages distinct functional domain of Auditors, Ombudsman and Regulator and espouses creation of 'Institution of Micro Finance Development and Equity Fund' (MFDEF). Incorporation of provision of penalty for the delinquent MFOs is a laudable feature. The bill focuses on microfinance services rather than the MFOs and tries to assimilate the regulatory function with that of encouraging the sector. Rare foresight at all standards! The report of the 'Committee on Financial Inclusion' 2008 while lauding this draft bill suggested that MFIs registered under Section 25 of Companies Act, 1956 can be included in the list in lieu of cooperative societies.

c) External Agency-Ordinance of Andhra Pradesh

Over the years the happenings in Andhra Pradesh sent a signal that MFI loans are available freely there, are addictive and are breeding seething displeasure. Survey revealed that out of a countrywide total MFI loan of Rs 463 billion, Andhra Pradesh itself had a loan of Rs 170 billion. Average MFI loan per household was about Rs 65,000. Problems simmered, on the issues of exorbitant rates of interest, corroding community ties, threatening economic security of the farmers and dubious methods of collection by MFIs. Skirmishes broke out right

¹⁰ 'Sa-Dhan Takes Lead: Implementation of Code of Conduct for MFIs' – Report in Business Standard August 30, 2010. Full text of the 'code of conduct' is available at www.sa-dhan.net/.../Sa-Dhan%20Code%20of%20Conduct%20final.pdf. MFIN code of conduct is available in www.mfinindia.org/mfin-code-conduct. (both visited on 5/5/2011)

¹¹ Full text of this bill (Bill No 41) is available at www.inafindia.in/MF_Bill_2007.pdf. (Visited on 5/5/2011)

from 2006 in parts of Andhra (Guntur, Krishna) and Karnataka (Kolar). Self regulation propagated by the MFIs to douse this discontent fell flat as they themselves gave it a lip-service. A spate of borrowers' suicides in 2010 only elicited a knee-jerk reaction and Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Ordinance, 2010¹², came into existence. Though criticized as providing 'band-aid' solution to a deep-seated malady the ordinance proposed-

- ❖ Registration of the MFIs indicating their areas of operation, rates and methods of collecting interest at DRDAs. Registration is liable to be cancelled on proven delinquency.
- ❖ Proactive disclosure of the rates of interest. Seeking of collateral under any garb is strictly banned.
- ❖ A blanket ban on multiple borrowings. SHG members also cannot take a second loan without the clearance of the registering authority.
- ❖ Authorised employees with identity card can only go in for recovery and that too in a public place. Creation of a toll free helpline number 15532. Provision of penal measures involving hefty fines and jail sentence for any deviance exhibited during collection of interest.
- ❖ Monthly submission of the detailed performance report (list of loaners, amount of loan and the rate of interest) to the DRDAs.
- ❖ The state government will soon establish fast track courts after consultation with the High Court for settlement of disputes of civil nature.

'Pre budget Economic Survey' (March 2011),¹³ held that around 30 million people were being served by 1,659 MFIs availing a total credit of Rs 13,955 crore. This calls for an impeccable functioning of the sector. Consequently the 'Survey' emphasized on

- Transparency in declaring and determining the interest rate by MFIs rather than capping the interest rate. Encouraging opaqueness and ambiguity in this field may lead to a sub-prime crisis as happened in advanced countries, the report warned.
- The coercive collection tactics should be thwarted sternly. Yet resorting to blanket ban on the business activities of MFI or declaring all-encompassing amnesties will make the sector vanish into the blue.

A sector with an annual growth rate of 51% is definitely a force to reckon with. Yet questions are posed not on their performance but on their methods of operation. The maladies which plague the sector basically hinge on multiple lending, shared clients and common JLGs. On the other hand they

¹² Andhra Pradesh Ordinance No 9 of 2010- The Andhra Pradesh Gazette art-IV-B Extraordinary.

¹³ Full text of Economic survey 2011 is available at <http://indiabudget.nic.in/index.asp>. (5/5/2011)

enjoy clear advantage in terms of a greater insight into the rural-poor-centric-issues, enjoy greater acceptability amongst their niche clients and display rare flexibility in operations providing a comfort level to their clientele. Self regulations, it seems, can hardly succeed without any official imprimatur. So to reap proper benefits from the MFIs, a proper whistle blower is absolutely crucial. The sooner it is in place the better!

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