

India

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Summary

There are some 60 million poor households in India, and while microfinance institutions (MFIs) have made a start in providing financial services to these households, their outreach is minuscule compared with the effective demand.

The Reserve Bank of India and a closely associated institution, NABARD, have undertaken a wide range of activities designed to support microfinance. However, many of these have been "developmental" initiatives of a financially repressive nature (such as directed credit requirements and refinancing of loans to priority sectors) and have not contributed to the emergence of a sustainable microfinance sector.

There is a need to shift the focus further in favor of promotional activities such as training and capacity building, and to promote understanding of the need for market-related interest rates. It would also be appropriate to establish prudential regulation and supervision for larger MFIs with client deposits.

India **Currency Equivalent**

Currency Unit – Indian rupee/s (Re/Rs)

US\$1 = Rs43.00 (at mid-1999)

Abbreviations

ASA	Activists for Social Alternatives Trust
CFTS	Cashpor Financial and Technical Services Limited
DCCB	district central cooperative bank
DFI	development finance institution
DICGC	Deposit Insurance and Credit Guarantee Corporation
GDP	gross domestic product
IDBI	Industrial Development Bank of India
IMF	International Monetary Fund
IRDP	Integrated Rural Development Programme
LAB	local area bank
MACS	Mutually-aided Cooperative Society
M-CRIL	Micro-Credit Ratings & Guarantees India Limited
MFI	microfinance institution
NABARD	National Bank for Agriculture and Rural Development
NBFC	nonbank finance company
NGO	nongovernment organization
PACS	primary agricultural credit societies
RBI	Reserve Bank of India
RMK	Rashtriya Mahila Kosh (National Women's Fund)
RRB	regional rural bank
SHG	self-help group
SEWA	Self Employed Women's Association, Ahmedabad
SIDBI	Small Industries Development Bank of India
SRO	self-regulation organization
UNDP	United Nations Development Programme

Note

In this report, "\$" refers to US dollars.

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Poverty remains widespread and investment in human development is inadequate

1 Introduction and Background

1.1 Human Development

India's population of nearly one billion (some 980 million at end-1998), and low per capita income (\$410 in 1997/98) are the major factors underlying all initiatives to promote the economic growth of the country. The annual population growth rate of 2.3 percent in the 1970s declined to 1.8 percent by 1996. However, though the poverty ratio declined from more than 50 percent to 35 percent (in 1995), the absolute number of poor in India increased from 164 million in 1951 to about 328 million by 1995. Poverty incidence is also characterized by rural-urban and inter-regional disparities. In rural areas, which account for around 75 percent of the population, the poverty ratio is in excess of 37 percent, whereas in urban areas it is around 32 percent. The poor are concentrated in the east and central regions of the country though other states also have substantial numbers of poor people. Thus, though there has been progress in reducing poverty, it remains widespread and constitutes a great burden for the economy as a whole, and its removal is a major challenge for the policymakers.

While growth with social justice and the alleviation of poverty have been the explicit objectives of government policy in India for many decades, low investment in human development continues to be an issue and a constraint. India's Human Development Index¹ for 1999 was 0.545 in 1997 which resulted in the very low international ranking of 132nd out of 174 countries. This reflects some very poor social indicators such as an adult literacy rate of just 53.5 percent. Nevertheless, due to the strained financial position of the states, which undertake about 90 percent of social sector spending, government expenditure on the social sectors has declined from 7 percent of gross domestic product (GDP) in 1990/91 to an average of 5.9 percent of GDP during the period 1992–1996. Yet the Gini² index for expenditure shares by percentile of population is 29.7 for 1994 and compares well with that for income or expenditure distribution of many developed countries (World Bank 1999).

1.2 Economic Performance

The economic crisis of 1991 resulted in a major reorientation of the economic policy regime in India from high regulation to the introduction of more market-based incentives for resource allocation and a more outward-oriented strategy aimed at fostering integration with the global economy. This, combined with sound macroeconomic management, resulted in a rapid recovery in GDP growth rate from just 0.8 percent in the crisis year of 1990/91 to an average of 7 percent during 1994/95–1996/97. However, political instability since 1996 and a sharp downturn in agriculture during 1997/98 have resulted in more sluggish growth of around 5 percent over the past two years. Despite the resulting increase in the fiscal deficit (to over 6 percent of

¹ As calculated by the United Nations Development Programme (UNDP) and presented in the *Human Development Report 1999* (1999).

² The Gini index appears in the literature, for example, World Bank (1999) and UNDP (1999), with a value between 0 and 100. This indicator is essentially the same as the Gini coefficient, with a value between 0 and 1.

GDP), inflation has remained low (below 5 percent as measured by the wholesale price index). The balance of payments is also reasonably strong with the current account deficit of 1.5 percent in 1997/98 being offset by strong inflows of foreign direct investment resulting in foreign exchange reserves of around \$26 billion — equivalent to some seven months' import cover.

Over the period 1980–1997, there has been a significant shift in the structure of the economy. The share of agriculture in value added has declined from 38 percent to 27 percent while services increased their share from 36 percent to 43 percent, and industry increased from 26 percent to 30 percent. This shift is not purely accounted for by the growth in modern services sectors such as computer software, management consultancy, financial services, and urban utility services but also by some growth in micro-enterprise sectors such as vending and petty trading. The latter is at least partially an indicator of the rise in absolute numbers of people affected by disguised unemployment or engaged in marginal employment, particularly in urban areas.

1.3 Financial Sector

The first financial sector legislation for India was passed in 1904 with the Cooperative Societies Act. Until the late 1950s, the cooperatives were the main institutional source of credit for all loans in rural areas. India's central bank, the Reserve Bank of India (RBI), was established under The Reserve Bank of India Act, 1934. The Banking Regulation Act, 1949 introduced a comprehensive system for the licensing of banks and branches, and conferred regulatory and supervisory powers on RBI.

A significant impetus to the growth of the financial sector was provided by bank nationalization from 1955 and by the government-promoted expansion of the cooperative banks in the 1950s and 1960s for the purpose of making agricultural credit readily accessible. Starting in 1975, the expansion of the rural banking network was encouraged through the establishment of district-level regional rural banks (RRBs) as subsidiaries of the major public sector commercial banks. At the same time, the cooperative network was further expanded through the establishment of village-level farmers' service societies. Concurrently, a further development in the financial sector was the growth of nonbank finance companies (NBFCs).³

The financial sector in India now incorporates a vast network of commercial banks, cooperative banks, and RRBs as well as other financial institutions such as development finance institutions, state-level finance corporations, NBFCs, insurance companies, provident funds, and mutual funds. There are more than 160,000 retail credit outlets in the cooperative and banking sectors, augmented by another 37,000 or so NBFCs. There are currently reported to be some 94,000 cooperative societies or branches of cooperative banks, over 45,000 branches of the 27 public sector commercial banks, and another 4,700 branches of 55 smaller private banks. In addition, there are 196 RRBs with some 14,400 branches, mainly in rural areas. There is also a growing number of foreign banks operating but their reach, through some 190 branches, is limited to the main cities (Reserve Bank of India 1998).

Financial services to the poor are provided mainly by the over 33,000 rural and 14,000 suburban branches of the major banks and RRBs and by the 94,000 cooperative outlets — either bank branches or village-level societies. RRBs, in particular, were established specifically to meet the credit requirements of the poor — small and marginal farmers, landless workers, artisans, and small entrepreneurs —

The economic policy regime has been shifting from regulation toward market-based incentives

The financial sector is vast: some 160,000 retail outlets of banks and cooperatives, and another 37,000 outlets of nonbank finance companies

3 The difference between banks and NBFCs is that the former can honor the checks of depositors whereas the latter are not allowed to undertake third party transactions on behalf of their depositors.

and should, therefore, have emerged as major sources of microfinance. A total of 140,000 credit outlets serving the rural sector and the poor implies the availability of one institutional outlet for every 5,600 persons. Financial services to the poor, or locationally disadvantaged, are also provided by the village or (town) neighborhood-level agents of NBFs as well as by numerous informal savings and credit associations common in many parts of the country.⁴

2 Development of Microfinance

Microfinance is defined by the Asian Development bank as “the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their microenterprises” (ADB 2000, 1). This definition is certainly relevant to the Indian situation and is employed for the purposes of this study.

2.1 Outreach and Sustainability

Bankers and senior government officers are fond of describing the Government of India’s main poverty alleviation program, the Integrated Rural Development Programme (IRDP), as the world’s largest program for providing micro-loans to poor people. And so it is. It involves the commercial banks giving loans of less than Rs15,000 to poor people and, in nearly 20 years, has resulted in financial assistance of around Rs250 billion to roughly 55 million families.⁵ The problem with IRDP is that its design incorporates a substantial element of subsidy (25–50 percent of each family’s project cost) and this has resulted in extensive malpractices and misuse of funds. The net result is that estimates of the repayment rates in “the world’s largest microfinance program” range from 25 to 33 percent. Thus, IRDP has affected the credibility of micro-borrowers and hindered the recycling of loanable funds by commercial banks. This has hindered the access of small borrowers, particularly the typically less literate poor, to banking services.

Similarly, the entire network of primary cooperatives in the country and RRBs — both sets of institutions established to meet the needs of the rural sector generally and the poor in particular — has proved a colossal failure.⁶ Having been saddled with the burden of directed credit and a restrictive interest rate regime, the financial position of RRBs deteriorated quickly while the cooperatives suffered from the malaise of mismanagement, privileged leadership, and corruption born of excessive state patronage and protection.

Over the past 20–25 years, the resultant vacuum in the financial system has started to be filled, initially with the pioneering efforts of the Self Employed Women’s Association (SEWA) Bank (Ahmedabad) and Working Women’s Forum (Madras), but more vigorously during the 1990s by the advent of significant numbers of nongovernment organizations (NGOs) into microfinance. Current estimates of the number of

India’s main poverty program, the IRDP, has negative consequences for the financial system

A vacuum in the financial system serving the poor has attracted alternative service providers

4 See Rutherford and Arora (1997) amongst other sources of information on rotating savings and credit associations, chit funds, and other informal means of obtaining finance.

5 This suggests that virtually all the 60 million or so poor families have been covered by IRDP. Unfortunately, this is not the case as the numbers include many cases of repeat assistance (deliberate) and perhaps even more cases of unjustified selection of “beneficiaries.”

6 For a more detailed discussion, see EDA Rural Systems (1996).

NGOs engaged in mobilizing savings and providing micro-loan services to the poor — roughly since 1994 — lie in the range of 400–500 organizations.

Initially, many of these NGO microfinance programs — better known in India as microfinance institutions (MFIs) — were funded by donor support in the form of revolving funds and administrative grants. In recent years⁷ the National Bank for Agriculture and Rural Development (NABARD), the Small Industries Development Bank of India (SIDBI), and microfinance promotion organizations such as the Rashtriya Mahila Kosh (RMK, the National Women's Fund) have also started to take an active interest in providing bulk loans to MFIs. This has resulted in MFIs becoming intermediaries between the largely public sector development finance institutions and retail borrowers consisting of groups of poor people or individual borrowers living in rural areas or urban slums. In another model, NABARD has taken to refinancing commercial bank loans to self-help groups (SHGs) in order to facilitate relationships between the banks and poor borrowers.

Though MFIs have made a start in providing financial services, primarily credit, to the poor, their outreach is still minuscule in comparison with the problem. The cumulative disbursements of bulk loans to MFIs by domestic financial institutions did not exceed Rs775 million (\$18 million) by September 1998 with an outreach to no more than 0.5 million families — at best less than 1 percent of the poor in India.⁸ Even allowing for a significant volume of donor grants, the total coverage is likely to be less than 1.5 million families.

It is apparent that the involvement of commercial banks in microfinance is negligible both in relation to the current volume of microfinance and (even more so) to their broader engagement in rural areas. The total credit from the scheduled commercial banks to the "weaker sections"⁹ is estimated at Rs290 billion (\$6.7 billion) at the end of March 1998 compared with the total rural deposits of Rs1,330 billion (\$31 billion).

Direct finance to MFIs is limited by continuing widespread skepticism about the credibility of micro-borrowers and failure to appreciate the potential for savings among the poor. By extension, this skepticism extends to the capacities of MFIs. The problem is compounded by the lack of exposure of most bankers to NGOs and MFIs and their consequent inability to assess adequately the latter's implementation capabilities. As a result, even in the case of the NABARD scheme for linking SHGs directly with banks, progress and outreach has been limited to just Rs180 million (\$4.2 million) disbursed and, at most, 200,000 families covered.¹⁰

MFIs in India operate in a situation that is characterized by some 60 million families living below the poverty threshold — perhaps 35 percent of the country's population. Yet, as the previous discussion shows, the cumulative outreach by MFIs to such families is no more than 1.5 million (2.5 percent). Thus, even without attempting any estimate of the effective demand for microfinance services among the poor, it seems there is likely to be a huge demand-supply gap for credit as well as a failure to exploit the potential for savings. MFIs in India have outstandings of around Rs450 million (\$10.5 million) from bulk lending institutions, roughly the same amount

The outreach of MFIs is minuscule, while the involvement of commercial banks is negligible

7 Roughly since 1994.

8 There is probably considerable double counting in these numbers and the real outreach is unlikely to be more than 0.8 percent of the total. Source of data is information available from EDA Rural Systems in India (1996, 1998).

9 "Weaker sections" — official parlance in India for the poor and underprivileged sections of society. Includes all families officially classified as poor but also some non-poor who belong to the lower caste categories of Hindu society or to specified groups of other religious minorities.

10 Bankers' attitudes which limit commercial bank exposure to microfinance are extensively discussed in Goodwin-Groen (1998).

In the market for microfinance services we see both a demand-supply gap for credit and a failure to exploit the potential for savings

from donors, and another Rs0.5–0.6 billion in member savings leading to a total of Rs1.4–1.5 billion in outstanding capital.¹¹ Such evidence as is available, on the other hand, suggests that effective demand is overwhelmingly in excess of this.

This impression is strengthened by information from the 43rd round of the National Sample Survey, which indicates that 53.6 percent of rural female workers expressed the need for assistance in the form of initial finance, and 22 percent felt a need for working capital facilities to undertake income-generation activities.¹² The issue of price is, of course, relevant to the effective demand for credit. Many observers believe that the 12.5 percent interest per annum limit of banks only limits the availability of capital to the poor who would be perfectly willing to borrow at anywhere from 30–50 percent interest per annum. The work of EDA Rural Systems (1996, 1998) shows that this is the case, and that the real issue for the poor is availability and access to micro-loans, not price.

2.2 Diversity of Models

A household's access to institutional credit improves as its income rises

Microfinance providers may be classified as those who operate in the formal sector and those operating in the informal sector. In the formal sector, banks, cooperatives, and NBFCs are the key institutions. In the informal sector, traders and moneylenders are the main sources while NGOs/MFIs may be classified as semi-formal. A 1996 study shows the informal sector as the credit market for the poorer households and that with an increase in household income, access to institutional sources of credit improves (BASIX 1996).

One of the reasons cited for the formal sector not being popular with the poorer households is their need for consumption credit, which is not usually offered by the formal sector institutions. The informal sector money market simply judges the creditworthiness of borrowers rather than the purpose of the loan.

Formal Sector

In this sector, credit is channeled to small borrowers mainly through cooperatives and banks. The formal sector microfinance providers are generally regarded as very bureaucratic and are characterized by high transaction costs, subsidized interest rates, and considerable procedural requirements. NBFCs also operate, through village and area-level agents, on the margins of the sector and are much more accessible and less bureaucratic. However, until now they have also been largely unregulated and less credible as trustworthy providers of finance. In recent years the development finance institutions — NABARD, SIDBI, the Housing and Urban Development Corporation — have emerged as wholesale providers of finance to MFIs, usually NGOs or SHG federations. More specifically, other than finance provided by commercial banks under the disastrous poverty alleviation schemes such as IRDP, the main formal sector sources of microfinance are as follows.

Primary Agricultural Credit Societies

The primary agricultural credit societies (PACS) operate at the village level and advance loans for productive purposes. Their short- and medium-term lending (six-month crop loans to three-year irrigation and other loans) is supported by district

Formal sector microfinance providers tend to be rather bureaucratic

11 Estimates based on the research of EDA Rural Systems and M-CRIL's developing MFI database.

12 The 43rd National Sample Survey findings indicate a significant demand-supply gap in availability of credit for rural women. It also states that latent demand could be much higher than the findings.

central cooperative banks (DCCBs) which make loan funds available to PACS. DCCBs, in turn, are supported and supervised by state cooperative banks. Through refinancing and supervision, the state cooperative banks provide the link between RBI and the national money market, on the one hand, and the lower levels of the cooperative credit structure, on the other.

In theory, the cooperative sector is a much easier source of finance than the banks. However, most of the tens of thousands of village-level PACS in the country are non-functional due to financial mismanagement, failure to mobilize village-level savings, and inability to recover dues. In 1984/85, only 56.5 percent of PACS are reported to have been working at a profit and in 1989/90 the proportion of overdues was reported at 40 percent. More than 50 percent of the overdues were more than three years old (Misra and Puri 1995).

Nonbank Finance Companies

NBFCs have a fairly extensive network of agents engaged in providing services at the village and urban neighborhood level. However, NBFCs function mainly as mobilizers of savings from the rural and suburban middle classes and it is only in recent years that they have started lending operations. Since these operations are predominantly oriented towards the financing of vehicles and consumer durables such as motorcycles, tractors, and television sets, they rarely serve the main microfinance needs of the poor. At present, there are only three NBFCs with a commitment to function as MFIs. These are BASIX, Hyderabad, Sangha Mitra of Bangalore, and CFTS, Mirzapur, Uttar Pradesh. Among the three, while CFTS could be classified as an MFI as its client focus is exclusively poor, in the case of BASIX, the focus is on the community which may cover non-poor as well. Sangha Mitra intends to make bulk loans to SHGs but has not started operations yet.

PACS are hamstrung by mismanagement and few NBFCs are committed to the microfinance market

Informal Sector

Traders, Moneylenders, Friends, and Relatives

Informal sources of finance are popular with low income and low asset-owning households. The main actors in this sector are traders/moneylenders, friends/relatives, neighborhood SHGs, revolving savings and credit associations of various forms, and NGOs. Poor women in particular tend to borrow small sums, frequently for domestic consumption purposes, and in a male-dominated society are less able to cope with formal mechanisms outside their local environments. For them, informal sources of finance represent an essential component of their daily lives, and the formal financial structure is still a mysterious element of the inaccessible world beyond. In this situation, the availability of finance, virtually at the doorstep, rather than its cost, is the crucial factor.

Informal Finance: Sources of Comparative Advantage

Informal sources of finance have continuing appeal for low income people, based on:

- their far greater accessibility — available quickly within the village or neighborhood and requiring virtually no paperwork
- their high degree of flexibility — terms and size of loans being negotiable and the purpose of borrowing mostly unrestricted.

These advantages should be incorporated, as far as possible, into MFI operations and supported by the policy, regulatory, and supervisory environment.

Most Indian MFIs are operating self-help group programs

Semi-formal Sector: NGO Microfinance Institutions

Amongst NGO MFIs, the following approaches are common (EDA Rural Systems 1996):

- (i) **SHG programs.** The operations of SHGs are based on the principle of revolving the members' own savings. External financial assistance augments the resources available to the group-operated revolving fund. Savings thus precede borrowing by the members. In many SHG programs, the volume of individual borrowing is determined either by the volume of member savings or the savings of the group as a whole. The vast majority of MFIs in India have SHG-based programs. Some of these are MYRADA, SPMS of Tirupati, the groups organized by the DHAN Foundation, Madurai and Chaitanya of Maharashtra. Many NGOs operate microfinance programs by organizing federations of SHGs to act as the MFI which channels external loan funds to the poor. The NABARD program is essentially a variation of this model but involves refinance for commercial bank loans direct to SHGs rather than via bulk loans to MFIs.
- (ii) **Cooperatives.** All borrowers are members of the organization either directly or, in the case of cooperative banks, indirectly, by being members of primary cooperatives or associations which are members of the cooperative bank. Creditworthiness and loan security are a function of cooperative membership within which peer pressure is assumed to be a key factor. The magnitude and timing of savings and loans are unrelated though a special effort is made to mobilize savings from members. There are only a handful of cooperative credit societies in India devoted specifically to providing financial services to the poor. Amongst these are SEWA Bank, Indian Cooperative Network for Women, Tamil Nadu, and the cooperative credit societies affiliated to the Hyderabad-based Cooperative Development Foundation. Over the past couple of years the Mutually-aided Cooperative Society (MACS) has emerged in Andhra Pradesh as a new type of institution with greater independence from government administrative controls than in the past. There are now a number of MACS, such as Mahila Vikasa, operating as MFIs.
- (iii) **Grameen replicators** (those following the model developed by the Grameen Bank of Bangladesh). These undertake individual lending but all borrowers are members of groups within which peer pressure is the key factor in ensuring repayment. Each borrower's creditworthiness is determined by the overall creditworthiness of the group. Savings are a compulsory component of the loan repayment schedule but do not determine the magnitude or timing of the loan. There are no more than 8–10 organizations in India known to be following this model. The prominent ones are SHARE, Activists for Social Alternatives Trust (ASA), and Rural Development Organization, Manipur.

The Grameen Bank model is of relatively minor importance in India

2.3 Regulation of Microfinance

The present level of regulation of microfinance in India is negligible. While informal moneylending is nominally not permitted, there is no effective control that can be exercised in a situation where formal record keeping is virtually unknown. Though primary cooperative societies are supervised by state-level departments of cooperation, both the technical competence and the motivation of the staff of these departments are questionable. Even the functioning cooperatives generally have a poor reputation as microfinance service providers. NBFCs, though nominally regulated by accounting and reporting requirements to the Department of Company Affairs as well as to RBI, are so numerous that, in practice, they have proved very difficult to regulate. The resulting incidences of fraud and default¹³ have, however, forced RBI to reconsider

13 Most spectacularly, in 1996, by a large NBFC called CRB Finance.

the situation and require all NBFCs to register with it, as well as to follow more stringent prudential norms than in the past. However, with over 45,000 NBFCs having applied for registration, the task of regulation remains huge in relation to the resources and capacity of RBI.

Regulation of microfinance is negligible

MFIs not registered as cooperatives or NBFCs are almost completely unregulated. They have only nominal reporting requirements under their registration as charitable societies or trusts, and no prudential regulation at all. Technically, most MFIs collecting client savings are in violation of Section 45S of the RBI Act, which prohibits the mobilization of public deposits — whether or not from members — without the specific permission of RBI. Nevertheless, in view of the implications of microfinance for the credit needs of the poor, RBI has, in practice, turned a blind eye to these activities. Instead, it has tacitly supported such unregulated public deposit taking through circulars encouraging banks to participate in the SHG linking scheme of NABARD, and by encouraging them to advance loans to NGOs for the purpose of on-lending to SHGs. Under RBI's directed credit requirements all such loans qualify for consideration as advances to the priority sector.

3 Role of the Central Bank

3.1 Mandate and Role of the Reserve Bank of India

The mandate and role of RBI includes maintaining monetary reserves for securing the monetary stability of the country and generally operating the currency and credit system of the country as well as acting as banker to the central government. RBI is also responsible for the development and maintenance of an effective payments system, development of financial markets and financial infrastructure, and prudential supervision of formal financial institutions — including both banks, other financial institutions, and NBFCs — as well as for deposit insurance.

The macroeconomic objectives of RBI are primarily the “pursuit of price stability and ensuring the availability of adequate credit to the productive sectors of the economy ...” (Reserve Bank of India 1998). The means of achieving these twin objectives includes the conduct of monetary policy, including exchange rate policy, and acting as lender of last resort. As discussed earlier, RBI has played a role in prudential regulation and supervision of the banks and the financial system since 1936, but the role was greatly strengthened after the two major episodes of bank nationalization in 1969 and 1980. It covers all segments of the formal financial sector including public, private, and foreign banks, RRBs, other financial institutions, and NBFCs. To this extent RBI certainly dominates the financial system in India, though with deregulation and liberalization in recent years, RBI's dominance has been deliberately reduced in most segments of the system.

RBI's dominance of the financial system has been reduced in recent years

3.2 The Central Bank and its Subsidiary Institutions

RBI's developmental objectives have resulted in its spawning a range of subsidiary development finance institutions (DFIs). Those DFIs with relevance for microfinance were established for:

- (i) Accelerating the flow of credit for agriculture and rural development (via NABARD).
- (ii) Directly providing credit facilities to small and micro-scale industries (SIDBI).

- (iii) Improving availability of funds for housing development, particularly for the poor (the National Housing Bank).
- (iv) Providing insurance cover to small depositors as well as undertaking third party guarantees on small loans advanced by the banking sector (Deposit Insurance and Credit Guarantee Corporation or DICGC).

Over the years RBI initiatives have plugged gaps in the financial structure at various times and facilitated the development of important segments of the financial system with varying degrees of success. In recent years, RBI has started to divest itself of the more successful (as well as the least successful) of these initiatives. Thus, RBI subsidiaries such as the National Housing Bank have yet to establish themselves convincingly as independently viable commercial entities, and therefore continue to be fully controlled by the Government either directly or via major shareholdings of other public sector institutions. DICGC, on the other hand, has accumulated huge losses and is on the point of being dissolved or heavily restructured.

RBI Subsidiaries Relevant to Microfinance

Development finance institutions established by the central bank, and with relevance for microfinance, were established for:

- accelerating the flow of credit for agriculture and rural development (via NABARD)
- directly providing credit facilities to small and micro-scale industries (SIDBI)
- improving availability of funds for housing development, particularly for the poor (National Housing Bank)
- providing insurance cover to small depositors as well as undertaking third party guarantees on small loans advanced by the banking sector (DICGC).

While promoting the development of financial markets, organizations such as NABARD and SIDBI also play a significant promotional role in developing instruments and mechanisms for promoting the flow of finance for their mandated economic sectors. Thus, for instance, NABARD has specific re-financing schemes for irrigation and watershed development projects, while SIDBI has a whole department for providing both subsidies and loans to small productive enterprises to enable them to test innovative ideas for marketing their products.

NABARD and SIDBI have experimented actively with providing microfinance and micro-enterprise development services

Both institutions also experiment with methodologies for enabling them to fulfill their mandates more efficiently. NABARD's program of linking microfinance SHGs with banks is one such experiment. Apart from providing wholesale loans (and administrative grants) directly to NGOs for on-lending to micro-borrowers, SIDBI has also experimented with the promotion of micro-enterprises through the provision of professional support for identified entrepreneurs. These are supply-led initiatives intended to encourage the commercial banks to take more interest in the very small borrower/producer at the small town and village level. These promotional activities are, of course, intended to reinforce the institutions' credit operations as are NABARD's other activities like the institutional development of cooperative banks and the organizational development initiative undertaken with RRBs since 1996.

3.3 Financial Repression

Repression of the financial sector in India takes several forms. These include all liquid asset requirements (cash reserve requirement and statutory liquidity ratio), priority sector credit allocation, preferential re-discount facilities, and credit guarantee schemes. The scheduled banks in India are required to maintain a minimum cash reserve with RBI. This requirement has been progressively reduced from around 15 percent of their net demand and time liabilities, some five years ago, to 10.5 percent today. The statutory liquidity ratio requiring the banks to maintain a portfolio of liquid assets (government and other approved unencumbered securities) has also been progressively reduced and is now limited to 25 percent of net demand and time liabilities over and above the minimum cash reserve requirements. This is the minimum level specified under the Banking Regulation Act. These ratios have been used as an instrument of monetary policy over the years and have greatly reduced the availability of credit in the system.

In the past RBI also controlled the cost of credit with a cap on interest rates chargeable for microfinance, and fixed levels of interest chargeable for other types of credit. These controls have gradually been removed during the liberalization that has taken place since 1991. The last controls on microcredit — a cap on interest rates of 12.5 percent per annum for all loans to small borrowers needing less than Rs25,000¹⁴ — were removed at the end of August 1996 for the cooperative sector and RRBs. With an increasing concern for the viability of the entire financial system, even this cap on the cost of microcredit was increased over the years and rose from around 10 percent per annum ten years ago to the 12.5 percent per annum limit of early 1996. It has now been altered further to a maximum level equivalent to the prime lending rate. So far as savings are concerned, interest rates payable on all time deposits were also gradually deregulated, and the specified rates have now been abolished altogether.

All banks — commercial banks, RRBs, and cooperative banks — are required by RBI to allocate 40 percent of their total advances to the priority sector. Priority advances are defined as loans for agriculture — both crop loans and loans for infrastructure development — loans to small and micro-enterprises, and an amorphous category of other sectors which includes housing loans and microfinance loans. The specific allocations to agriculture, small/micro industry, and other sectors are required to be 18 percent, 12 percent, and 10 percent respectively of their overall credit portfolio.

Traditionally, commercial banks reluctant to put resources into large numbers of relatively small loans have found ways of reducing their transaction costs. Thus, in recent years, with the liberalization of RBI's definitions, increasing funds have been lent to NABARD and SIDBI by commercial banks — albeit at relatively low rates of interest — in order to increase the ratio of priority sector advances on commercial bank balance sheets. Banks have generally failed to meet the requirements of priority sector advances. Over the period from 1991/92 to 1996/97, the levels achieved by the public sector banks ranged between 30 percent and 35 percent with the State Bank of India recording an average of around 27 percent — this despite the fact that the bulk of such lending is promptly re-discounted by NABARD, SIDBI, or one of the other DFIs.

It is in order to provide further encouragement to banks to lend to the same priority sectors that the credit guarantee schemes were launched with the establishment, in 1971, of DICGC. Since it was mandatory for commercial and rural banks to participate, the Small Loan Guarantee Scheme of the corporation covered 50 percent of principal and accrued interest, up to 1995, on 80 percent of all small loans provided

Financially repressive measures continue to be applied

Priority sector lending requirements remain, but banks fall short

¹⁴ Including larger loans to groups of borrowers such as SHGs who cumulatively borrow more than Rs25,000 but individually require much less.

Credit guarantees have been ineffective in supporting priority sector lending

in India. However, the scheme was a colossal failure as extensive defaults on directed credit schemes resulted in a high level of claims which rendered the whole scheme uneconomic, and the corporation found it impossible to handle the large volume of claims.¹⁵ By 1997, when the scheme was made optional for the banking system, banks had voted on the scheme by default and deserted it to the extent that claims received declined from some 6.0 million in 1996/97 to just 0.54 million in 1997/98 (Reserve Bank of India 1998). Most banks have now created their own risk funds to insulate themselves from the defaults occurring in directed credit schemes.

3.4 Regulation, Supervision, and the Independence of RBI

Rules framed under the Banking Regulation Act of 1949 require all scheduled commercial banks, RRBs, and cooperative banks in India to submit to the licensing, regulation, and supervision of RBI.¹⁶ In practice, this has meant licensing by RBI for all banks but inspection and supervision of only the commercial banks, since the job of inspecting RRBs and cooperative banks has been delegated to NABARD, and supervision of RRBs to the “parent” commercial banks. However, the licensing of bank branches has remained the direct responsibility of RBI and this, together with the allocation of restricted “service” areas to individual rural branches of banks, has effectively restrained competition. Though licensing policy has been greatly liberalized in recent years, effective competition in rural areas continues to be limited by the reluctance of the public sector banks to break the mold from the social(-ist) orientation of the past.

Public ownership of banks resulted in their use to promote developmental and social objectives

As the previous discussion shows, ownership of most of the banking sector by the Government has resulted in the use of the public sector banks to promote its developmental and social objectives in other ways as well. Commercial objectives have not been given much importance and the incentives for appropriate loan assessment and monitoring of performance did not receive much attention, as managers were unlikely to suffer the consequences of bad loan decisions. Both managers and regulatory authorities focused excessively on quantitative indicators such as growth in lending and deposits as well as branch expansion rather than on costs, credit quality, and the capacity of borrowers to service loans. Directed lending forced banks to lend in non-viable areas at interest rates that did not reflect the risks involved. Thus, nonperforming assets in priority sector lending were higher than in other areas, and historically high cash reserve requirements and statutory liquidity ratio requirements resulted in reduced returns on bank asset portfolios.

In keeping with this relatively lax banking culture, income recognition norms until 1992/93 allowed banks to recognize interest due but not paid as income, and to make inadequate provisions for nonperforming loans. The problem of such loans was compounded by periodic loan waiver schemes, and corrective action on problem accounts was deferred as debt recovery procedures were inadequate and bank claims were difficult to enforce through the legal system. This lax regime also resulted in considerable fraud in the banking system which came to light only with the tightening of norms in the early 1990s.

The economic crisis of 1990/91, however, resulted in a considerable tightening of norms for the banking sector and much greater and closer supervision. Annual memorandums of understanding between RBI and the major commercial banks were introduced in 1993. These memorandums set up performance criteria related to profitability, internal controls, modernization, capital adequacy, nonperforming loans,

15 By 1995, there were 4.8 million claims outstanding (Graham Bannock & Partners 1997).

16 Much of the discussion in this section is derived from International Monetary Fund (1998).

and business growth which have to be met during the financial year 2000/01. The weakest banks have been placed under close surveillance, and it is only those that meet certain minimum standards which have been given relative autonomy in their administration and recruitment. A committee was also appointed to consider the issue of banking sector reform and made a number of recommendations in the areas of prudential regulation, supervision, disclosure, and the recapitalization and structural transformation of the financial system (Government of India 1998). The recommendations of the committee are now in the process of being implemented and, together with the earlier reforms, have resulted in improvements in asset quality and transparency of the banking system.

As is apparent from this discussion, conforming to the picture of typical developing country central banks (Fry 1998), RBI was fully subservient to the Government of India 25 years ago. However, the reforms of recent years have also brought relief to India's central bank in the form of substantial independence, to the extent that interest rate policy is now subject to discussion between the Government and RBI. Interest rate policy is not believed to be government directed any longer. On regulation and supervision of the banking sector also, the reforms of the 1990s have brought near-complete independence to the central bank.

Economic crisis at the beginning of the 1990s stimulated banking reforms

4 Central Bank Support for Microfinance Initiatives

4.1 Perceptions of RBI about Microfinance

Starting with a circular issued in 1991 which exhorted banks to participate in NABARD's pilot program for linking SHGs with commercial banks, microfinance has received increasing recognition by RBI in recent years. The central bank's perceptions about microfinance are apparent from its 1996 circular which reviewed the experience of the pilot program:

... the efficacy of the SHGs as an effective mode of rural savings mobilization and credit delivery to the poor has been demonstrated in the pilot phase and since the linkage of targeted 500 SHGs has already been achieved, it has been decided to extend the SHGs linkage program beyond the pilot phase as a normal business activity of banks to improve the coverage of the rural poor by the banking sector. Accordingly banks may consider lending to SHGs as part of their mainstream credit operations both at policy and implementation level (Reserve Bank of India 1996).

The circular not only indicated the continuation of the pilot program as mainstream banking activity but also clarified that lending to SHGs and/or NGOs for the purpose of on-lending could be included in the priority sector lending requirement. RBI's active support was, however, limited to this level until November 1998 when the governor of RBI attended the Policy Forum on Microfinance organized by Women's World Banking in Ahmedabad. Emerging from the forum was crystallization of RBI's increasing interest — a decision taken, at the instance of the governor, that NABARD should constitute a task force on microfinance. The objective of forming the task force was to “arrive at a conceptual policy framework for sustainable growth of microfinance in the country encompassing issues in policy, regulation, financing and capacity building.”

The task force completed its work in July 1999 and the final report, incorporating specific recommendations for regulatory and promotional measures to be taken by

Central bank circulars extolled the value of bank-SHG linkages during the 1990s

RBI and/or the Government, was presented to the governor of RBI in October 1999. Amongst the key recommendations were:¹⁷

- (i) **Introduction of regulation and supervision of MFIs by means of self-regulation organizations (SROs).** These would be registered as nonprofit organizations “evolving from the MFI sector.” SROs would need to be recognized by RBI, and a mechanism for the purpose of recognition would need to be worked out in consultation with all institutional stakeholders in the microfinance sector, including MFIs. Until SROs emerge, regional offices of RBI or agencies designated by RBI would need to undertake this task.
- (ii) **Introduction of compulsory registration with the regulatory authority for all MFIs.** Regulation and supervision would be limited to MFIs that have mobilized savings in excess of Rs200,000 (\$4,650). MFIs with savings deposits in excess of Rs2.5 million (\$58,000) would be registered with and regulated by a national rather than a regional authority.
- (iii) **Introduction of reserve requirements.** Ten (10) percent of savings mobilized would be placed in bank deposits by organizations with client savings in the range Rs200,000 to Rs2.5 million, and 15 percent of savings mobilized for organizations with client savings in excess of Rs2.5 million. Apart from reporting to a national authority the latter would have to comply with prudential norms that are specified by RBI “if necessary in consultation with NABARD.”
- (iv) **Treatment of MFIs as bodies corporate for the limited purpose of Section 45S of the RBI Act.** This is in order to mobilize savings only from their poor clientele as part of the financial services provided to them. The RBI Act would be amended, if necessary, to provide for this. MFIs mobilizing deposits from members of the public besides their poor borrowers or clients would have to comply with the existing regulations of RBI and would not be covered by these provisions.
- (v) **Introduction of a special dispensation for MFIs registered as NBFCs provided they are registered under Section 25 of the Companies Act as not-for-profit organizations.** Such companies would not be required to follow the regulatory and minimum capitalization norms of other NBFCs but would be subject to the prudential norms applied to MFIs. They would be granted exemption from income tax under Section 12A of the Income Tax Act. The aim of this recommendation is to enable and encourage the professionalization of the microfinance sector.
- (vi) **Mainstreaming and up-scaling of the program for linking SHGs with commercial banks.** This is designed to achieve the target of linking one million SHGs with commercial banks by 2008. There was recognition of the need to make funds, of the order of Rs3 billion (\$70 million) up to 2008, for capacity building of NGOs and MFIs engaged in the creation of SHGs for this purpose.
- (vii) **The establishment, at NABARD, of a microfinance development fund.** The fund would be established with an initial start-up contribution of Rs1 billion (\$23 million) from the Government of India and with annual contributions from the profits of RBI and NABARD. The fund would be used to support capacity building of MFIs including creation of hardware, and provision of equity and start-up grants for meeting deficits in the initial years of MFI operations.

RBI has facilitated the participation of NBFCs in microfinance

During the presentation, the governor of RBI promised that the recommendations of the task force would be examined in detail and appropriate measures would be taken. However, he did not offer much hope of any kind of regulation being introduced. It was his view that regulation would only result in bureaucratic restrictions on the activities of MFIs. In January 2000, RBI announced that NBFCs undertaking the business of microfinance and registered under Section 25 of the Companies Act would

17 The following recommendations consist of a synthesis of the chapter, Summary and Recommendations (NABARD 1999).

NABARD Task Force on Microfinance: Key Recommendations

- Introduction of regulation and supervision of MFIs by means of SROs.
- Introduction of compulsory registration with the regulatory authority for all MFIs.
- Introduction of reserve requirements.
- Treatment of MFIs as bodies corporate — in order to mobilize savings only from their poor clientele as part of the financial services provided to them.
- Introduction of a special dispensation for MFIs registered as NBFCs provided they are registered under the Companies Act as not-for-profit organizations — to enable and encourage the professionalization of the microfinance sector.
- Mainstreaming and up-scaling of the program for linking SHGs with commercial banks — to achieve the target of linking one million SHGs with commercial banks by 2008.
- The establishment, at NABARD, of a microfinance development fund — to be used to support capacity building of MFIs.

no longer be subject to the strict registration and prudential requirements of other NBFCs.¹⁸ Another circular, issued 25 February 2000, clarified that bank lending to microfinance, whether through SHGs or MFIs, could be included in the priority sector lending requirements imposed upon them. The banks were, thereby, encouraged to lend to the microfinance sector based on their own selection criteria for MFIs, and also given freedom to set their own interest rates for this purpose.¹⁹

In February 2000, the finance minister announced in his budget speech to Parliament the creation of a Rs1 billion fund for the promotion of microfinance along the lines requested by NABARD. However, at the time of writing (May 2000), this had not yet been operationalized. RBI has exempted NBFCs registered under Section 25 of the Companies Act as not-for-profit companies from some of the regulatory requirements, but in practice such companies are still not allowed to raise deposits and they are effectively limited to lending activities. Therefore, much remains to be done to realise the recommendations of the task force.

4.2 Developmental Activities for Microfinance

As discussed in Section 3, many of the initiatives of RBI, particularly in the 1970s and 1980s, were aimed at achieving developmental and social objectives. The stated objective of the whole gamut of initiatives was to ensure access and limit the cost of credit to the vast majority of relatively poor potential borrowers in rural areas. Specifically, these initiatives included nationalization of the major commercial banks, directed credit (requirements to lend to the priority sectors), interest rate regulation (especially lending to the poor at a differential interest rate of 4 percent per annum), and credit guarantees for small loans. Currently, much of the priority sector lending is undertaken with refinance from NABARD though measures like interest rate

18 Notification issued by the Department of Non-Banking Supervision of RBI on 13 January 2000.

19 Statement issued by RBI quoted in *The Economic Times* (2000).

One restriction remains: RBI holds down the interest rate on microcredit lending by commercial banks to their prime lending rate

regulation and credit guarantees have fallen by the wayside. NABARD uses mainly its own funds — contributed as share capital or borrowed from RBI for this purpose though some programs are financed by the Government. Finances for the Rural Infrastructure Development Fund, for instance, are allocated by the Department of Finance to NABARD as budgetary provisions. Refinance of small loans (below Rs25,000) is at 6.5 percent per annum for RRBs and cooperative banks, and 8.5 percent per annum for commercial banks.

The only form of regulation still applicable for microfinance by the banking system is that the rate of interest charged by commercial banks to the final borrower is capped by the prevailing prime lending rate. In early 2000, prime lending rates of most commercial banks were around 15 percent per annum. With RBI's circular of 24 April 1999, however, banks were allowed the discretion to set their own interest rates for loans to MFIs and SHGs. While RRBs and cooperative banks are not subject to any interest rate regulation even for direct microfinance, this measure of deregulation has not had any practical impact on the availability of credit to small borrowers. The reason for this is that perceived political and social pressures have limited the interest charged by RRBs and cooperative banks to the levels charged by commercial banks on loans less than Rs25,000. Interest rates paid on savings by RRBs and cooperative banks tend to be a little higher than those paid by commercial banks but, at between 0.25 and 0.5 percent per annum, these differences are not significant.

In the current economic situation in India, however, the issue of interest rates may be entirely different from the presumed upward pressure on lending rates which might be expected to result from deregulation. With annual inflation at 3–5 percent, bank lending rates of 15–18 percent per annum are now so high in real terms as to be crippling for large investors. Yet, banks with historically high levels of nonperforming assets and inefficient operational systems are reluctant to reduce margins. As a result, while there are positive incentives for savers in the system, borrowers are poorly served. In the long run, the issue for RRBs, local area banks (LABs), and cooperative banks may not be so much whether or not they are able to increase their lending rates substantially as whether they can improve efficiency to levels at which even the current lending rates may be profitable. RBI could, perhaps, facilitate this by promoting the idea of new loan windows that adhere to the norms of credit discipline applied in modern microfinance, while accounting separately for their more conventional loan products which have historically high levels of nonperforming assets.

4.3 Promotional Activities for Microfinance

RBI's macroeconomic management has been a positive contribution to microfinance

RBI has played a constructive, if indirect, role in microfinance by ensuring price stability in the country. While the average annual rate of inflation in India over the past 12 years has been around 9.8 percent, over the period 1995/96 to 1998/99 consumer price increases have been even lower, in the range of 7–8 percent (Government of India 1999). This has enabled microfinance activities to be undertaken in the country in an atmosphere of economic stability, facilitating financial planning by MFIs and protecting the value of the savings of the poor clients served by MFIs.

The two main direct initiatives of RBI in promoting microfinance have already been referred to. The SHG linking program of NABARD has received increasing emphasis during the past few years and, as already discussed, is now being encouraged as a regular program of the banking sector. By March 1999, this program is reported to have linked some 33,000 SHGs and covered approximately 560,000 families.²⁰

²⁰ NABARD (1999). This is a cumulative figure. A more realistic figure for SHGs with loans outstanding under the program is likely to be of the order of 20,000 covering some 350,000 families.

Developmental and Promotional Activities of Central Banks

Developmental activities include:

- participating in the capital and management of development institutions
- mandating priority sector lending
- administering differential interest rates, and preferential rediscount rates and credit facilities.

The promotional role is activity that generates externalities and reduces transaction and information costs within the financial system.

This can include:

- support for pilot projects using innovative approaches to provision of financial services
- conduct of research
- collection and publication of data
- advocacy, leadership, and training.

Source: Chandavarkar (1996)

Most of the scheduled banks in India are said to have participated in the program which had reached 279 of the 650 or so districts in the country and involved the participation of 545 NGOs.

A few banks have apparently become closely involved in the SHG linking program. These include Canara Bank amongst the major commercial banks. The Bank of Madura Ltd — a private commercial bank — is said to have found the program so satisfactory that it has been adopted as part of its strategy for achieving viability for its 104 rural branches. The experience of a handful of RRBs and district cooperative banks is also reported to be extremely good. So enthusiastic is NABARD's management with the program that it has now set itself the target of reaching one million SHGs by the year 2008, up from an expected 75,000 SHGs to be linked during 1999/2000.

However, the financing of the program by NABARD has until now been from a special fund contributed by the Swiss Agency for Development and Cooperation. This Rs550 million Credit and Financial Services Fund is used partly as a revolving fund for refinancing the SHG linkage program, and partly to make bulk loans to NGOs undertaking experimental endeavors in the direct implementation of microfinance. It is also used for microfinance training, exposure, and capacity building of both bank and NGO staff.

As already discussed, RBI's senior management has now fully recognized that microfinance is a desirable goal and they would like to assist the financial system in increasing the focus on it. It is for this reason that RBI's governor encouraged the formation of the microfinance task force to advise it on the appropriate promotional and regulatory framework for microfinance. In April 1999, a microcredit special cell was also created at RBI. The objective of the cell — staffed by a senior commercial banker familiar with microfinance — was to identify and suggest practical measures for making microfinance a sustainable and “marketable product” for the entire financial system. It was expected that the cell would take account of the recommendations of the microfinance task force (as summarized in Section 4.1) and undertake extensive discussions with banks and MFIs before making its recommendations. The measures announced by RBI in January-February 2000 (already referred to) resulted partly from the recommendations of the cell.

RBI has established a “special cell” for microfinance which is active in policy and promotion

5 Regulation and Supervision of Banks

5.1 Licensing and Minimum Capital Requirements

As noted already, nonbank MFIs are not permitted to accept deposits from the general public. Indeed, the legality of their acceptance of client savings as deposits is questionable within the provisions of Section 45S of the Reserve Bank of India Act. For this reason, under the present dispensation, MFIs could only legally expand their sources of funds and provide a full range of microfinance services to poor clients if they are either well-established NBFCs, with substantial owned funds, or have banking licenses.²¹

A commercial banking license is beyond the financial resources of MFIs but some are operating as urban cooperative banks

The possibility of obtaining such banking licenses is constrained at the first level by the minimum capital requirements which vary for different types of banks. In the case of private commercial banks, this minimum requirement is as high as Rs1 billion (\$23.2 million). This naturally limits the scope for establishing the kind of small banking structure that would be able to operate locally, as MFIs do, in order to focus on services to small borrowers.

A more likely route — one taken by the well-known MFI, SEWA Bank — is that of establishing small urban cooperative banks. The minimum capital requirements for such banks range from Rs5 million (\$116,000) in large metropolitan areas, Rs1 million (\$23,000) in small metropolitan areas, to just Rs10,000 (\$230) in suburban areas. In the past such banks have been allowed to operate only in one urban area. Though SEWA Bank has now been allowed to operate in some rural areas, the extent to which it would be possible for an MFI, under these provisions, to obtain a banking license to operate predominantly in rural areas is still unclear.

As noted in Section 2.1, the 196 RRBs in the country were nominally established to serve the needs of small borrowers (mainly) in rural areas. Having been saddled with the burden of directed credit and a restrictive interest rate regime, the financial position of RRBs deteriorated drastically. The RRB rehabilitation efforts of the 1990s have resulted in a turnaround of most RRBs but usually at the expense of high cost rural lending which was, unfortunately, unsustainable in the earlier regime of controlled interest rates. Most RRBs have now increased interest rates on savings deposits and improved customer service to facilitate deposit mobilization. However, given their historically high ratio of nonperforming loans (a large proportion of which were made under IRDP), they have become exceedingly credit-shy and prefer to place their funds in the comforting embrace of the Mumbai money market. RRB credit-deposit ratios are reported to be as low as 20–30 percent.²²

RRBs have proved a disappointment, but the local area bank (LAB) model may prove to be a suitable vehicle for microfinance

It is in order to make up for the failure of RRBs that RBI created a special provision in 1996 for the establishment of local area banks (LABs). These banks were conceived essentially as private sector RRBs. They were to offer full banking services in three geographically contiguous districts and be subject to the same regulatory regime as RRBs. The minimum capital requirement for such banks was fixed at Rs50 million (\$1.2 million). However, there was immediately concern about the ability to raise this level of private capital in order to operate in such a localized area. Further, there was also pressure from the established commercial banks against these provisions. In practice, three years later, no LAB has been established. The general

21 The discussion in this section is modified and adapted from McGuire et al. (1998).

22 This low credit-deposit ratio of RRBs, along with the success of large NBFCs such as Sahara and Peerless in the poorest regions of eastern India, is yet another indicator that the demand for savings services is very substantial and far higher than is often realized by MFIs themselves.

perception is that political pressure from public sector bank employees' unions has resulted in RBI prolonging the licensing process, although it is progressing.

5.2 Interest Rate Regulation

As reported earlier, interest rate regulation is now limited to a maximum of the prime lending rate for loans up to Rs200,000 made by scheduled commercial banks. There is no interest rate regulation at all for RRBs, cooperative banks, and the (proposed) LABs but, to date, perceived social and political pressure has in practice limited interest rates to the levels charged by the major commercial banks. However, as discussed in Section 4.2, mere deregulation may not be sufficient, in the short to medium term, in ensuring that the public benefits from increased efficiency. A more proactive initiative by the central bank may be required for this purpose (and is discussed in the recommendations in Section 7.2).

5.3 Prudential Regulation and Supervision

All types of banks in India face roughly the same prudential requirements. Banks, other than cooperative banks, are subject to a capital adequacy ratio of 8 percent of risk weighted assets. In the case of cooperative banks, the share capital is linked to the volume of loans disbursed, and this provision is equivalent to a capital adequacy ratio of 7.5 percent. These requirements are not an impediment to banks' microfinance activity. Indeed, it has been suggested that it may be too low for small banks like RRBs. Most commentators suggest that the higher risk associated with small institutions requires higher ratios — of the order of the 20 percent capital adequacy requirement now expected to be imposed on NBFCs.

The cash reserve requirement of 3 percent of net demand and time liabilities for RRBs, LABs, and cooperative banks is quite low whereas the 10 percent requirement for commercial banks is now being reduced. However, though the 25 percent statutory liquidity ratio is high by international standards, it does not appear to have acted as an impediment to microfinance lending as many banks maintain larger proportions of their assets in government and other zero-risk instruments. On the other hand, it may in the future act as a disincentive for MFIs wanting to establish banks.

All banks have to fulfill the same requirements on income recognition and loan loss provisioning based on the Basle Accord. The reporting requirements are also the same for all banks and involve a series of fortnightly, monthly, quarterly, and annual reports. Cooperative banks have slightly less onerous reporting requirements in recognition of their more limited range of activities. An urban cooperative bank involved in microfinance has reported that these requirements are rigorous but realistic and that the bi-annual on-site inspection by RBI is positive and useful.

There are no statutory collateral requirements or restrictions on unsecured lending in India, though there are separate reporting requirements for unsecured loans. This separate requirement has been reported by one major MFI to be an impediment to borrowing from banks. A bank manager is said to have argued both that it would make him look irresponsible and that the bank being approached would need to make immediate provisions for default. The latter is not correct; provisions are required only for loans in arrears not on standard (on time) loans, whether secured or not. On the contrary, RBI's circular to the commercial banks regarding participation in the SHG linking scheme has specifically discouraged them from seeking collateral as opposed to the group guarantees and peer pressure on which the concept of SHGs is based. Thus, the reporting requirement on unsecured loans is not a real impediment to microfinance lending. Nevertheless, in many bankers' perceptions, it continues to be one.

Despite RBI assurances, non-collateralised lending is a problem for many bankers

The supervision of commercial banks and cooperative banks is undertaken directly by RBI which has specialized departments for this purpose and sends out inspection teams approximately every two years. RRBs, on the other hand, are supervised on an ongoing basis by their parent commercial banks (since all RRBs are subsidiaries of commercial banks) but inspected by NABARD. RBI has mandated the latter for this purpose. Powers to undertake punitive action or order corrective measures, nevertheless, vest with the central bank which acts, if required, on the basis of NABARD's findings.

6 Regulation of Nonbank MFIs

As discussed in Section 2.3, there are no specific regulatory provisions relating to MFIs beyond the administrative and simple accounting requirements of charitable societies, trusts, and even state-level cooperative laws. Currently, there are absolutely no provisions in which RBI plays a role except in the very few cases where NBFCs and one urban cooperative bank are involved in microfinance in a major way. Indeed, RBI's involvement/facilitation, until April 1999, was more by omission — in ignoring the implications for MFIs of Section 45S of the RBI Act — than by commission.

7 Conclusions and Recommendations

7.1 Conclusions

Despite RBI's increasingly supportive attitude, no institutional framework for regulation of microfinance has emerged yet

It is apparent from the discussion in this paper that the Reserve Bank of India (RBI) has historically been cautiously supportive of microfinance. During the period 1998–2000, however, it has become increasingly active in support of microfinance though it has not yet reached the stage of accepting the need to regulate the microfinance sector. This is, at least partly, on account of the perception that microfinance, being a poverty reduction activity, should be undertaken mainly by the nongovernment organization (NGO)/microfinance institution (MFI) sector rather than by a professional set of organizations subject to basic prudential norms and financial regulations. As a result, no institutional framework has yet been created for this purpose though the Government of India has clearly supported the creation of SIDBI's (Small Industries Development Bank of India) Foundation for Micro-Credit and, as indicated earlier, the creation of a fund for microfinance development was also announced in the budget for 2000/01.

In this context, the general perception on the part of the MFI sector is that while the movement of policy is in the right direction, it is not as wholehearted as is desirable for the establishment of microfinance as a professional service. Indeed, two MFI networks, Sa-Dhan and Indnet in early 2000 commissioned studies of the appropriate form and content of self-regulation with the aim of submitting more detailed recommendations on this issue to RBI.

Clearly, there is a huge job remaining to be done in India in meeting the unmet effective demand for credit by the poor. A multi-pronged effort to promote microfinance in an orderly and responsible manner is required. This effort would take into account the availability of savings in the rural sector and the potential for recycling

these savings for the economic benefit of the poor rather than in the Mumbai money market. This could happen through MFIs — both large and small — and efficient regional rural banks (RRBs), local area banks (LABs), and cooperative banks with stringent prudential regulation but competitively determined pricing norms. The confidence generated by prudential regulation would bring resources into the system while an emphasis on opportunity, efficiency, and competition would play an important role in providing access to credit and other microfinance services for the poor.

Prudential regulation would engender confidence and bring resources into the system

7.2 Recommendations

The following recommendations are made for action by RBI. For convenient reference, they are summarized in Appendix 1.

(1) RBI should promote understanding that higher interest rates provide increased access to finance for the poor rather than exploiting them.

With the removal of interest rate restrictions on small loans generally, the interest rates chargeable by commercial banks can, theoretically, be increased to the prime lending rate. However, under perceived political pressure most banks have failed to increase their lending rates for loans of amounts less than Rs25,000. Also, in the case of cooperatives, though there are no official restrictions on the interest they charge their members, state governments have, in practice, imposed restrictions through their administrative controls. All these restrictions are tribute to the political pressures that still place limitations on responsible governance in India. RBI could play an important role here in encouraging management of banks to ensure that they focus on the availability of loans for the poor rather than on low interest rates that only result in the exclusion of the poor from the banking system. At the same time, RBI and the Government would have to initiate a public education campaign on the need for realistic interest rates to be charged on small loans.

Change perceptions about interest rates

(2) RBI should draft a new MFI Act which can act as the legal framework for microfinance activity in a maturing sector.

There is a need to clarify the situation in relation to savings mobilization in the context of Section 45S of the RBI Act. For this reason, it is generally accepted that there should be an immediate dialogue either on appropriate amendments to the RBI Act or the enactment of a new, separate law specifically drafted to facilitate and regulate microfinance. It is recommended that, as in other countries of South Asia, a new law should be drafted for microfinance.

Under this law, supervision of an MFI would be triggered by the mobilization of client savings in excess of Rs200,000 (\$4,600), as recommended by the microfinance task force. The nature of such supervision is discussed later. Again, as recommended by the task force, MFIs generating in excess of Rs2.5 million (\$58,000) in client savings should be required to register as a special category of microfinance NBFCs which would be directly supervised by RBI.²³ In this dispensation, savings mobilization from nonmembers would automatically require registration as nonbank finance companies (NBFCs) as this would not be classified as legitimate MFI activity under current Indian legislation. However, the availability of the NBFC institutional model enables an MFI to overcome this obstacle.

An MFI Act is needed to clarify the savings issue

23 As proposed to be recommended by the microfinance task force after its discussions in Lucknow on 24–25 July 1999. EDA Rural Systems (1998) suggests a separate legal framework for such NBFCs to be known as Vikas Nidhis (Development Funds).

(3) RBI should establish prudential regulation and supervision structures for microfinance organisations which are appropriate to their size.

With increasing numbers of organizations (often very small) becoming involved in microfinance, it is generally accepted that it is impractical and, to some extent, even counter-productive to attempt to regulate and supervise all MFIs. As recommended by the microfinance task force, those mobilizing more than Rs200,000 in client savings should be supervised by MFI networking organizations acting as “self-regulation organizations” (SROs). The mandate for undertaking this regulation and supervision should be entrusted to these organizations by RBI under the proposed new law. As suggested in the previous paragraph, however, RBI should retain the powers to supervise and regulate the larger MFIs with client deposits in excess of Rs2.5 million.

Since MFIs generating more than Rs2.5 million in savings would, in the Indian context, be of a significant size, they should be required to register as mutual benefit companies under Section 620 of the Companies Act. These MFIs would, as mutual benefit companies, be equity funded and have a clear ownership structure. This would facilitate more rigorous prudential regulation and supervision (in principle at least) directly by RBI. Even if direct supervision is limited by RBI’s resources, the requirement to adhere to reporting requirements will enable some degree of off-site supervision.

Tailor arrangements for prudential regulation and supervision to the size of MFIs

For the purpose of establishing regional-level SROs, it is unlikely that a sufficient number of MFI networking organizations with adequate technical competence and resources to function as SROs will emerge in the near future. For this purpose, RBI could work out a “hybrid” approach which uses the skills of any technically competent organizations (such as firms of chartered accountants or consultancy companies) that have a good understanding of and exposure to microfinance (Berenbach and Churchill 1997). In this dispensation, the work of regulation and supervision would effectively be contracted out, with the regulators subject to oversight and reporting requirements to be specified by RBI.

(4) The central bank should develop prudential norms and reporting standards for MFIs, in consultation with major stakeholders in the sector.

Though there are no commonly accepted performance and reporting standards for MFIs in India at present, the need for these is widely acknowledged. The linkage of the trigger conditions for prudential regulation and supervision to the volume of savings (or deposits) generated by an MFI is essentially to protect the savings of poor families from unscrupulous or irresponsible operators. MFIs that work almost entirely with funds obtained as grants from donor organizations or loans from apex institutions could, in this scheme, be subject only to the performance standards specified by the lender, and therefore would not need to be supervised. Since donors operating in India, in particular, are increasingly focusing on capacity building and promotional grants to MFIs rather than on providing loanable funds, it is unlikely that many MFIs could become sustainable, or even survive, in the long run as credit-only organizations. This is because they will be forced to look to commercial sources of loanable funds, including savings mobilization. Hence, they will be drawn under the prudential regulation and supervision umbrella put in place to protect depositors.

In the case of prudential regulation by organizations mandated for this purpose by RBI, MFI performance and reporting standards are yet to be worked out. In this case, it is recommended, as suggested by the microfinance task force, that RBI specify the standards to be applied by the regulators — preferably in consultation with MFIs and other institutional stakeholders in microfinance — such as the National Bank for Agriculture and Rural Development (NABARD), SIDBI, and other major wholesalers. For the purpose of developing and applying

these standards, as well as for the oversight of the MFI regulators, RBI may need to create a permanent (but small) cell of its own officers with an interest and specialization in microfinance.

(5) RBI should sponsor workshops and other activities that encourage commercial bankers to view the microfinance sector as a business opportunity.

Most of the apex institutions working with MFIs are large public sector institutions such as NABARD, SIDBI, and the Housing and Urban Development Corporation, all of which are subject to the regulation and direct or indirect supervision of RBI. Other non-official apex agencies such as Friends of Women's World Banking, India and Rashtriya Gramin Vikas Nidhi (National Rural Development Fund) are constituted as registered societies and are not, therefore, currently subject to such supervision. Implementation of the microfinance task force proposals would, of course, also subject these latter agencies to RBI supervision, as they would then be required to register as mutual benefit microfinance companies (tentatively termed Vikas Nidhis).

Further, the commercial banks need to be persuaded to view wholesale lending to microfinance as a business opportunity with commercial potential. Default rates by MFIs are far lower than those even of large industry, and transaction costs are unlikely to be higher in the long run. As in the case of large industry, there are now rating services available for MFIs in India, and the commercial banks could use these to reduce their lending costs in the early stages and monitor the performance of MFIs in the long run. SIDBI's Foundation for Micro-Credit is already using MFI rating services to inform its lending decisions and commercial banks could do the same. The process of encouraging the banks to take microfinance more seriously would also be facilitated by the advent of microfinance companies. In providing wholesale finance the banks would then be able to enter into contracts with a clear legal entity and a transparent ownership structure.

RBI issued a number of circulars and statements in early 2000 encouraging the banks to lend to MFIs and SHGs. It has also required banks to report microfinance lending separately and to include such lending in their credit plans. The process could be continued and reinforced through the increased exposure of commercial banks to MFI functioning via sponsored seminars, workshops, and field visits at which the experience of wholesale lenders like NABARD and SIDBI could be shared. RBI could take the initiative in this process.

(6) The central bank should select five regional rural banks to undergo capacity building with a focus on microfinance as core business.

Finally, the vast network and infrastructure of RRBs should, ideally, be revitalized in order to meet the objectives for which it was originally established. Reorienting these public sector organizations to provide services to the poor efficiently and in a client-friendly manner would be a gigantic task. It would require attitudinal changes at management level — initially to view the poor as creditworthy — and at staff level to view the poor as customers rather than supplicants. For this reason, a start should be made by selecting a few RRBs (say, five) in different regions of the country to focus on micro-enterprise lending and microfinance as their core business.

For this pilot program to be successful, a substantial technical assistance/capacity-building exercise would have to be undertaken with the selected RRBs. However, if even a couple of these pilot experiments were to be successful, they would serve as models for all other RRBs. This would likely open the doors to further incremental change with the potential to benefit far larger numbers of poor clients than the entire microfinance sector is presently capable of reaching.

Revitalize some RRBs as an example to the industry

(7) The central bank should monitor the effectiveness of funds used to support the professionalizing of the microfinance sector.

With the establishment of a Rs1 billion microfinance development fund at NABARD, and together with substantial funds available at SIDBI and the larger MFI support organizations, there now appear to be substantial funds available for this purpose. The use of these funds should be monitored to ensure they are deployed effectively to support the professionalization of the microfinance sector. This could be done by the RBI's microfinance supervision cell.

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Appendix 1: Role of the Reserve Bank of India in Microfinance in India: Summary of Recommendations

Issues in Microfinance in India	Measures Taken by the RBI/Government of India	Recommendations for Establishing a Professional Microfinance Sector
Interest rate control	All controls removed except in the case of loans <Rs25,000 by commercial banks.	Public education to change perception that increased interest rates necessarily imply exploitation of the poor. Change focus to access to finance.
Savings mobilization	MFI's registered as not-for-profit NBFCs under Section 25 of the Companies Act exempted from registration requirements of RBI.	Draft a new MFI Act which can act as the legal framework for microfinance activity in a maturing sector.
Prudential regulation and supervision	No measures proposed at present.	RBI should establish a cell to authorize MFI networks or technically competent service providers to act as SROs for all MFIs with savings deposits in the range Rs0.2–2.5 million. Larger MFIs should be required to register as mutual benefit companies under Section 620 of the Companies Act. Supervision would be direct by the microfinance cell of RBI, and the prudential norms would be stricter as well.
Performance and reporting standards	No standards developed so far.	RBI's microfinance supervision cell should develop prudential norms and reporting standards for MFIs including mutual benefit microfinance companies (Vikas Nidhis) in consultation with major stakeholders in the microfinance sector
Wholesale lending to MFIs	Interest rates for wholesale lending to microfinance completely de-controlled; banks reminded that such loans qualify for inclusion in its priority sector lending requirement; banks directed to include MFI/SHG lending as a separate category in credit plans and performance reporting.	A major effort is required to orient commercial bankers to view the microfinance sector as a business opportunity. RBI could sponsor or stimulate workshops, seminars, and field visits of commercial bankers for this purpose.
Retail microfinance by the banking sector	Interest rates deregulated but no other initiatives taken.	Select five RRBs in different regions of the country to undergo a technical assistance/capacity-building exercise concentrating on micro-enterprise lending and microfinance as their core business. The success of any of these five pilots would open the doors for a wider emphasis of RRBs on retail lending to poor clients.
Capacity building and start-up capital	Rs1 billion microfinance development fund to be established at NABARD to provide capacity-building support and start-up capital to MFIs.	Along with substantial funds available to SIDBI and to the larger MFI support organizations, there now appear to be substantial funds available for this purpose. The effective utilization of these funds to provide support to MFIs for the professionalization of the sector needs to be monitored.

MFI = microfinance institution, NABARD = National Bank for Agriculture and Rural Development, NBFC = nonbank finance company, RBI = Reserve Bank of India, RRB = regional rural bank, SHG = self-help group, SIDBI = Small Industries Development Bank of India.

Appendix 2: Persons Consulted

Acharya, Dr. Sarthi	ADB Domestic Consultant for India Country Consultation, now at the International Labour Organization
Arora, Mr. Sukhwinder S.	Enterprise Adviser, Department for International Development (United Kingdom)
Bakshi, Dr. P.	Chief General Manager, National Bank for Agriculture and Rural Development
Bhatt, Ms. Ela	Chairperson, Self-Employed Women's Association
Capoor, Mr. Jagdish	Deputy Governor, Reserve Bank of India
Chaudhury, Mr. B.	Chairman, Dhenkanal Gramin Bank (RRB)
Krishnamurthy, Mr. A.	General Manager, Andhra Bank
Kumar, Mr. Alok	Director, Banking Division, Ministry of Finance, Government of India
Kumar, Mr. M. Uday	Executive Director, SHARE
Mahajan, Mr. Vijay	Managing Director BASICS Ltd (the BASIX group)
Misra, Ms. Indira	(former) Executive Director, Rashtriya Mahila Kosh
Mohan, Mr. Brij	Chief General Manager, Small Industries Development Bank of India
Nanda, Mr. Y. C.	Managing Director, National Bank for Agriculture and Rural Development
Narain, Dr. S.	Managing Director, Small Industries Development Bank of India
Ramanathan, Mr. S.	Program Officer, Swiss Agency for Development and Cooperation
Sheokhand, Mr. S. M.	General Manager, National Bank for Agriculture and Rural Development
Thorat, Mr. Y. S. P.	Principal, Bankers' Training College, Reserve Bank of India
Tomar, Mr. J. S.	General Manager, Oriental Bank of Commerce and Officer on Special Duty, Microcredit Cell, Reserve Bank of India
Verma, Mr. B. R.	Chief General Manager, Rural Planning and Credit Department, Reserve Bank of India
Vyas, Ms. Jayshree	Managing Director, SEWA Bank
Warrier, Mr. M. G.	Deputy General Manager, Reserve Bank of India