PERILS AND POSSIBILITIES OF MICROFINANCE: NEED FOR REGULATORY REFORMS IN INDIA

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In the last few years, the poor in India, especially in rural areas, have been suffering from an acute credit crisis. This is a key reason behind the ongoing consumption slowdown, income stagnation, and loss of livelihood. The Covid-19 pandemic has worsened the situation by taking away livelihood in both rural and urban areas. Going ahead, one of the key players that can resolve the credit crunch problem is the microfinance industry. However, Microfinance Institutions (MFIs) themselves suffer from various operational issues due to inadequate or unsuitable regulatory provisions. The lack of proper regulations has also troubled consumers, and caused farmer suicides and political disturbances resulting in a prevailing sense of mistrust against MFIs in various parts of the country. Furthermore, questions are being raised as to how effective MFIs have been in fighting poverty. All these issues can be tackled only when there are prudent and effective regulations in place. Regulations must incorporate rules dealing with, amongst other things, data regulation, consumer protection, principal-based interest rate policy, the creation of a specialized regulatory body, and financial literacy. This will help unleash the true potential of MFIs, providing them with the necessary fuel for structured growth and extending credit and financial services to the unbanked.

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CONTENTS

INTRODUCTION

> "*When the poor at the bottom of the pyramid are treated as consumers, they can reap the benefits of respect, choice, and self-esteem and have an opportunity to climb out of the poverty trap.*"
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> — C.K. Prahalad[1]

Today, we have moved far away from the days when microfinance was touted as that rare poverty alleviation tool which could actually cause a crack in the cycle of poverty.[2] Microfinance, an integral part of Indian rural banking and financial inclusion policy, involves giving small doses of credit to the poor, who are expected to use it for productive activities and to scale up their businesses. However, in recent times, microfinance has come under intense scrutiny. This is primarily because today, microfinance is bigger than mere credit delivery. Its rapid commercialization has metamorphosed it into a galaxy of institutions[3] which provide a bouquet of financial services to the poor, especially those in the rural area. These services may be categorized into microcredit (which involves extending loans), micro-savings (which provide avenues to save and invest), micro-insurance (which provided means to mitigate risks),

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[1] C. K. PRAHLAD, THE FORTUNE AT THE BOTTOM OF THE PYRAMID 120 (2005).
[2] Kentaro Toyama, *Lies, Hype, and Profit: The Truth About Microfinance*, THE ATLANTIC (Jan. 28, 2011), https://www.theatlantic.com/business/archive/2011/01/lies-hype-and-profit-the-truth-about-microfinance/70405/.
[3] In India, these include Banks, Non-Bank Financial Company-Microfinance Institutions ("NBFC-MFIs"), Regional Rural Banks, Co-operative Banks and Societies, Non-Governmental Organizations, and Not for Profit Companies.

and money transfer.[4] Prior to such commercialization and privatization, microfinance was dominated by the public sector, NGOs, and cooperatives. Since then, multiple private companies, seeing value in microfinance, have entered the field, creating a massive fortune in the process and extending the formal financial network to a major part of the population.[5] The importance of Microfinance Institutions (**MFIs**) can be gauged from their widening and deepening reach across the country. In financial year 2019-20, there were over 14,275 MFI branches with over 1.16 lakh employees; 62% of these branches provided door-step credit to low-income clients.[6] MFIs are expected to play a key role[7] in over 125 of the 185 districts identified by the Reserve Bank of India (**RBI**) as India's most backward in financial accessibility[8]. Furthermore, the loan portfolio of MFIs is growing at the rate of over 30% and stands at Rs. 2.36 trillion as of 2020.[9] It is also pertinent to note that India accounts for almost a quarter of the global microfinance industry.[10] Furthermore, MFIs are becoming a key part of priority sector lending by banks. In the financial year 2019-20, MFIs raised a total of Rs. 357.59 billion in debt funding from banks, marking a 63% increase from the debt funding of Rs 219.67 billion in 2018.[11]

While MFIs have shown impressive commercial growth, in the last few years, questions have been raised as to their effectiveness and the sustainability of their business models.[12] In India, this debate entered the limelight due to a huge crisis that unfolded in the state of Andhra Pradesh, which had the largest concentration of microfinance customers in the country in the year 2010. This crisis was triggered by a spate of suicides linked to microfinance defaults.[13] At the centre of it was SKS Microfinance, a listed NBFC, which has now changed its name to

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[4] ERNST AND YOUNG, CHALLENGES IN MICROFINANCE 1 (2014), https://pdf4pro.com/cdn/an-ey-perspective-5044.pdf.
[5] Rajesh Chakraborthy & Kaushiki Sanyal, *Microfinance and Financial Inclusion in India*, *in* FINANCIAL INCLUSION IN ASIA: ISSUES AND POLICY CONCERNS 209, 211 (Sasidharan Gopalan & Toomoo Kikuchi eds., 2016).
[6] Advait Rao Palepu, *Agents, MFIs Key To Expanding Priority Sector Lending To Low Credit Districts*, BLOOMBERG QUINT (Sept. 10, 2020), https://www.bloombergquint.com/business/agents-mfis-key-to-expanding-priority-sector-lending-to-low-credit-districts.
[7] *Id*.
[8] Reserve Bank of India, Master Directions – Priority Sector Lending (PSL) – Targets and Classification, RBI/FIDD/2020-21/72 (Issued on Sept. 4, 2020, updated as on Apr. 29, 2021).
[9] *Microfinance industry sees 31% rise in loan portfolio at Rs 2.36 lakh crore in FY20: Report*, FINANCIAL EXPRESS (Nov. 9, 2020), https://www.financialexpress.com/industry/banking-finance/microfinance-industry-sees-31-rise-in-loan-portfolio-at-rs-2-36-lakh-crore-in-fy20-report/2124799/.
[10] PwC INDIA, VISION OF MICROFINANCE IN INDIA 6 (2019).
[11] *Id*, at 12.
[12] Navjot Sangwan, *Loan sharks are circling for poor Indian debtors failed by microfinance*, THE GUARDIAN (Oct. 29, 2018), https://www.theguardian.com/global-development/2018/oct/29/loan-sharks-circling-poor-indian-debtors-failed-by-microfinance.
[13] *Big trouble for microfinance*, THE ECONOMIST (Dec. 2, 2010), https://www.economist.com/free-exchange/2010/12/02/big-trouble-for-microfinance.

Bharat Financial Inclusion.[14] Of the 30 women who first died by suicide in Andhra Pradesh due to the pressure tactics of loan-sharks, 17 were customers of SKS.[15] The crisis witnessed politicking, the introduction of knee-jerk regulations, media trials, the loss of customers, an increase in default rates, and overall distrust as to the success of microfinance. However, it highlighted one important thing: microfinance, which was hitherto unregulated, must be regulated. Regulations were necessary to keep knee-jerk policies and politics at bay, safeguard consumers, prevent reckless short-term profit strategies, and provide a rules-based structure to the overall industry. Consequently, the RBI initiated a consultative process which culminated in the creation of a series of rules and regulations governing microfinance.[16] Since then, the regulatory structure of MFIs has changed significantly, creating many successful and impactful companies. Bandhan Bank, a fast-growing private lender, started as a microfinance institution. The trust which it was able to create with its customers, enabled the bank to transform into a full-service bank, which today continues to have over 61% exposure to microfinance.[17] This shattered the existing view that an MFI needs abusive tactics to maintain repayment and profitability.

Nonetheless, many areas of concern remain. MFIs have time and again requested policy-makers to frame necessary regulations.[18] Civil society groups too have been demanding that the corpus of rules in place must be suitably modified to ensure that focus is shifted away from commercial objectives towards the original aim of microfinance: defeating poverty.[19]

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[14] Vishwanath Nair, *SKS loses its final connection with the microfinance crisis—its name*, LIVEMINT (May 5, 2016), https://www.livemint.com/Companies/JLuCeEZX07hS9K13F3sKnO/SKS-loses-its-final-connection-with-the-microfinance-crisis.html.

[15] *Id*.

[16] Vijay Mahajan & T. Navin, *Microfinance in India: Lessons from the Andhra Crisis*, in MICROFINANCE 3.0: RECONCILING SUSTAINABILITY WITH SOCIAL OUTREACH AND RESPONSIBLE DELIVERY (D Kohn ed., 2013) 10-11, https://core.ac.uk/download/pdf/81178564.pdf.

[17] Nupur Anand, *The story behind India's biggest banking IPO began with rural women*, QUARTZ INDIA (Mar. 7, 2018), https://qz.com/india/1223219/bandhan-bank-from-rural-women-to-indias-biggest-banking-ipo/; *Bandhan Bank to gradually pare micro credit exposure: Chandra Sekhar Ghosh*, LIVEMINT (Mar. 12, 2020), https://www.livemint.com/industry/banking/bandhan-bank-to-gradually-pare-micro-credit-exposure-chandra-sekhar-ghosh-11583991443392.html.

[18] Sahib Sharma, *India's microfinance industry showing signs of overheating, again*, LIVEMINT (Jan. 30, 2017), https://www.livemint.com/Industry/jsZV2fupinFSXnmv4xsDNL/Indias-microfinance-industry-showing-signs-of-overheating.html; Saiba Paul, *Four major risks facing microfinance in India*, BUSINESS TODAY (Nov. 4, 2019), https://www.businesstoday.in/opinion/columns/microfinance-in-india-four-major-risks-facing-the-sector-rbi-nbfc-sector-banking-sector/story/388372.html.

[19] Bibhu Ranjan Mishra, *India needs a specialised regulatory authority for microfinance: Muhammad Yunus*, BUSINESS STANDARD (Feb. 8, 2016), https://www.business-standard.com/article/finance/india-needs-a-specialised-regulatory-authority-for-microfinance-muhammad-yunus-116020700604_1.html.

With this backdrop in mind, this paper is an attempt to highlight the lacunae in the current set of regulations governing the microfinance sector, and suggest necessary changes to improve its effectiveness, both for companies and society. Part I provides an overview of the current set of regulations governing the microfinance sector. In Part II, problems with the current regulatory regime are highlighted. These include the lack of data protection guidelines, the absence of a sector-specific regulator, the absence of consumer protection rules, issues with interest rate caps and so on. In Part III, suggestions are made to bring about rules that will enhance the social impact of microfinance. These include mandating community meetings and including MFIs in disaster-contingency plans.

I. CURRENT REGULATORY REGIME FOR MICROFINANCE IN INDIA

After the crisis in Andhra Pradesh, the RBI constituted the YH Malegam Committee, whose report forms the basis of the regime governing microfinance today.[20] Based on this report, the RBI introduced two important notifications. The first accorded priority sector status to MFIs. As a result, banks can lend to MFIs[21] under the priority lending requirement of 40%. The second notification created a new class of institutions called the NBFC-MFIs;[22] MFIs were given the status of Non-Banking Financial Corporations (**NBFCs**), and guidelines were issued for their regulation. The foremost problem that the notification addressed was that of the overleveraging of clients due to loans extended by multiple MFIs at the same time. To resolve this, borrowers have been limited to borrowing from only two MFIs at a given point in time.[23] Further, the total amount of debt that a borrower can take on has been capped at Rs. 1,00,000.[24]

The second important issue addressed by the notification was that of the high interest rates charged by MFIs. The RBI has tried to resolve this by prescribing a set of formulae to determine interest rates. The maximum interest rate which can be charged by an MFI is either 10% above the cost of its funds or the average base rate of the top five commercial banks multiplied by a factor of 2.75.[25] Furthermore, the interest rate can exceed 26% only when the

[20] Tamal Bandopadhyaya, *Microfinance: To Hell and Back*, LIVEMINT (Oct. 19, 2015), https://www.livemint.com/Opinion/Z3YLSgcdQxb4VygrbRW6EL/Microfinance-To-hell-and-back.html.
[21] RBI Master Direction on Priority Sector Lending – Targets and Classification ¶ 11, RBI/FIDD/2016-17/33 (2016); *see also* RBI Master Direction on Priority Sector Lending – Targets and Classification ¶ 21, RBI/FIDD/2020-21/72 (2020)
[22] Reserve Bank of India, Master Circular- 'Non-Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) – Directions, RBI/2015-16/20 (Issued on July 1, 2015, updated as on Apr. 20, 2016).
[23] *Id*. ¶ 2(C)(b)(II)(c).
[24] *Id*. ¶ 1(ii)(c).
[25] *Id*. ¶ 2(C)(a)(ii).

differential between the minimum and maximum interest charged by the MFI is less than 4%.[26] Additionally, in order to maintain pricing transparency, the only factors which may be included in the final pricing of loans include the interest rate, processing fee not in excess of 1% of the gross loan amount, and insurance premium.[27]

The third issue which was addressed was that of the reasonableness of the process. To prevent MFIs from behaving unfair towards borrowers, several measures were introduced, including prohibiting the charging of penalties for delayed or pre-payment, prohibiting MFIs from asking for security deposits or collateral, permitting repayment periods which may vary between a weekly, fortnightly or monthly basis as per the borrower's choice, prohibiting the use of coercive methods of recovery, and requiring that the repayment period be no lesser than 24 months if the loan amount exceeds Rs. 30,000.[28]

The fourth issue which has been tackled is that of borrowing money for consumption smoothing as against income generation. Money borrowed for consumption smoothing – that is, taking out a loan for consumption – is very difficult to repay, and it doesn't have the desired anti-poverty impact.[29] As against this, when a loan is given out for income-generating activities, it directly attacks poverty, is more likely to be repaid, and improves the financial standing of the borrower. To nudge MFIs towards lending primarily for income-generating activities, the RBI has mandated that the total value of loans extended for such activities must be over 50% of the overall loans advanced.[30]

Finally, to ensure industry discipline, it has been mandated that all MFIs must be members of credit bureaus, and provide them with necessary data.[31] Credit bureaus are bodies which take data from MFIs, and provide credit ratings to borrowers and present financial reports on the health of the various MFIs.[32] This move created databases, where member MFIs are supposed to deposit information about their consumers and their lending activities.[33] This

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[26] *Id*. ¶ 2(C)(a)(iii).
[27] *Id*. ¶ 2(C)(b)(I)(a).
[28] *Id*. ¶ 1.
[29] Subhabrata Bobby Banerjee & Laurel Jackson, *Microfinance and the business of poverty reduction: Critical perspectives from rural Bangladesh*, 70 HUMAN RELATIONS 63, 73-77 (2017).
[30] Reserve Bank of India, Master Circular- 'Non-Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) – Directions, RBI/2015-16/20 (Issued on July 1, 2015, updated as on Apr. 20, 2016) ¶ 1(ii)(f).
[31] *Id*. ¶ 2(C)(b)(III).
[32] WORLD BANK, https://www.worldbank.org/en/publication/gfdr/gfdr-2016/background/credit-bureau (2016).
[33] Reserve Bank of India, *supra* note 30, at ¶ 2(C)(b)(III); Gharad Bryan et al., *Sharing once hidden information: Credit bureaus, MFIs, and client welfare*, IGC (Mar. 2, 2017), https://www.theigc.org/blog/sharing-once-hidden-information-credit-bureaus-mfis-and-client-welfare/; Bureau, *Credit bureau for MFIs launched*, THE HINDU

empowered the MFIs to access information about the financial status and indebtedness of their borrowers. As a result, MFIs could refrain from lending to consumers who are already in debt, avoiding the problem of over-lending. Such information availability was also important to ensure that the cap on borrowing by a consumer (fixed at Rs. 1,00,000) can be implemented.

Apart from these regulations, the RBI has also allowed MFIs to act as Business Correspondents for banks.[34] Thus, MFIs can now supply various financial products like pension, insurance, remittance, and so on, to their customers. They can use their staff to extend banking services to places which don't have bank branches. The other important measure taken by the RBI was to accord Microfinance Institutions Network (**MFIN**) and Sa-Dhan, the two main industry bodies, the status of Self-Regulatory Organizations.[35] These organizations today carry out activities like, *inter alia*, issuing code of conducts, grievance redressal, investigations, data collection and awareness-raising.[36]

These regulations and measures have been appreciated by the industry and have had an overall positive effect.[37] However, there are many gaps in the regulations, which are yet to be filled; this will be discussed in the next section.

II. WHAT AILS THE CURRENT REGULATORY REGIME?

Even though MFIs aim to lend to the poor, the poorest of the poor continue to remain outside their fold.[38] A recent study found that about a fifth of the population continues to lack access to formal credit.[39] This is primarily because of the stringent limits placed on the interest rates that MFIs can charge. While it is desirable that some sort of limitation be imposed on

BUSINESS LINE (Nov. 10, 2017), https://www.thehindubusinessline.com/money-and-banking/Credit-bureau-for-MFIs-launched/article20105272.ece.

[34] Reserve Bank of India, Financial Inclusion by Extension of Banking Services - Use of Business Facilitators and Correspondents, RBI/2005-06/288 (Issued on Jan. 25, 2006) ¶ 3.

[35] Saurabh Kumar, *Sa-Dhan gets self-regulatory organization status after MFIN*, LIVEMINT (Mar. 12, 2015), https://www.livemint.com/Money/PcpbZpYM9ZNCgOkIw96gfN/SaDhan-gets-selfregulatory-organization-status-after-MFIN.html.

[36] *Id*; *see also* Bureau, *supra* note 32.

[37] Deepti Kc et al., *Effects of Reserve Bank of India (RBI) Regulations on Public Sector Lending for Micro Finance Institutions (MFIs)*, IFMR RESEARCH CENTRE FOR MICRO FINANCE (Oct. 2011), https://www.findevgateway.org/paper/2011/10/effects-reserve-bank-india-rbi-regulations-public-sector-lending-microfinance.

[38] C. H. Venkatachalam, *Public Sector Banking and the Unmet Expectations of Rural India*, THE HINDU CENTRE FOR PUBLIC POLICY (Dec. 15, 2017), https://www.thehinducentre.com/the-arena/current-issues/article9998934.ece.

[39] *India's banking revolution has left its villagers behind*, ECONOMIC TIMES (July 17, 2018), https://economictimes.indiatimes.com/industry/banking/finance/banking/indias-banking-revolution-has-left-its-villagers-behind/articleshow/65019590.cms?from=mdr.

interest rates in order to avoid exploitation, imposing a margin along with a prohibition on asking for collateral is not recommended. This is because the more distant an individual is from formal finance, the costlier it is to service her. Hence, the cost which MFIs bear in servicing the poorest of the poor tends to be higher. In such situations, apart from the cost of the fund, the cost to the MFI will also include fixed costs of making, monitoring, and servicing small loans, and variable costs due to the higher risk in lending to the poorest of the poor. The risk of lending is further accentuated by MFIs being prohibited from asking for collaterals and security deposits. In such a situation, the limited breathing space provided by the current regulatory framework pushes MFIs away from lending to the poorest sections of society. As the former governor of the RBI, Dr. Raghuram Rajan, has noted, "*you cannot limit interest rates, prohibit the taking of collateral, and still expect the borrower to have the same level of access to loans*".[40] The end result is that the poorest people turn to usurious moneylenders who charge unimaginably high interest rates and employ highly exploitative practices.

A potential solution to this conundrum is to allow MFIs to differentiate between consumers who have collaterals and those who do not. The RBI should allow MFIs to charge households which do not have collateral a higher interest rate, and those with collateral a lower interest rate. While this may force some to pay a slightly higher interest rate and others to pledge their assets, it mitigates the greater evil of many being completely left out of the formal financial network. The other solution to this issue is bringing down high interest rates, without placing margins and caps, by fostering competition outside the industry. While competition within the industry is known to be high, there is insufficient competition from outside.[41] Informal lenders, like moneylenders, can be a source of such competition. If moneylenders were nudged towards charging lower interest rates and away from employing exploitative practices, they may create healthy competition in the market. This can be done by giving licenses to moneylenders. Upon agreeing to be regulated, moneylenders may be given access to cheaper finance from the public sector, which they can further lend to the people. While most states have laws governing moneylenders[42], such statutes mandatorily require them to be regulated, as against using incentives to make it desirable for them to be regulated. Hence, these laws have failed to have any impact and require suitable changes.

[40] Raghuram Rajan, *The Changing Paradigm for Financial Inclusion*, RESERVE BANK OF INDIA (July 18, 2016), https://www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1010.
[41] *Id*.
[42] For example, the Karnataka Money Lenders Act 1961.

The second important concern is that of the prohibition on the acceptance of deposits by NBFC-MFIs. The RBI has imposed such a blanket prohibition, as it perceives NBFC-MFIs to be unsafe for holding deposits.[43] This is mainly because MFIs are insufficiently regulated and their chances of continued existence are substantially lower than that of banks. However, this policy takes away from MFIs what could be an important source of funds. Reports suggest that MFIs are struggling to survive due to a lack of funding.[44] In such a scenario, their only options are to merge with banks or to secure Small Finance Bank (**SFB**) licenses. The RBI has been very conservative in awarding SFB licenses, and even when it does so, licenses largely go to payment banks, which do not have a widespread rural presence.[45] Thus, it would be prudent to allow MFIs to accept deposits with a set of necessary regulations to ensure the safety of such deposits.[46] This will also allow MFI clients to deposit money directly with MFIs, as against depositing them in banks through MFIs which act as Business Correspondents. This will reduce the additional agency costs which were imposed due to the MFIs acting as agents for the banks and charging commissions for their services.

Third, the issue of data protection, of clients as well as MFIs, has completely been ignored, even though data breaches have become commonplace. The Planning Commission noted in 2011 that exploitation of, and discrimination against, clients by using their data is a possible scenario.[47] It was also noted that given that MFIs are required to share their data with credit bureaus, regulations protecting their trade secrets are urgently needed. No action has been taken in respect of either issue. With respect to individuals, it must be kept in mind that multiple kinds of institutions, which include both regulated bodies like MFIs and unregulated bodies like co-operatives and NGOs, continue to provide microfinance services. In this process, they acquire significant amounts of data, most of which has been digitized today. As such, it has become very easy to breach or sell such data, violating the client's privacy. This becomes even more sensitive when one takes into account the fact that most of the consumers of microfinance are poor people in rural areas, who form an important part of political

[43] Reserve Bank of India, Master Circular- 'Non-Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) – Directions, RBI/2015-16/20 (Issued on July 1, 2015, updated as on Apr. 20, 2016) ¶ 1.
[44] Atmadip Ray, *Microfinance institutions are struggling for survival. Here's why*, ECONOMIC TIMES (Oct. 04, 2017), https://economictimes.indiatimes.com/industry/banking/finance/microfinance-institutions-are-struggling-for-survival-heres-why/articleshow/60931020.cms.
[45] Sunny Sen, *New small finance bank licenses on the way*, MONEYCONTROL (Sept 06, 2019), https://www.moneycontrol.com/news/business/new-small-finance-bank-licenses-on-the-way-4410851.html.
[46] WORLD BANK, *India: The Regulation of Microfinance – An Analysis of Recent Proposals* (2010).
[47] PLANNING COMMISSION OF INDIA, A HUNDRED SMALL STEPS: REPORT OF THE COMMITTEE ON FINANCIAL SECTOR REFORMS 158 (2011).

constituencies and are easy to target.[48] The illegal trading of data for political reasons has become one of the biggest challenges of our times.[49] In 2019, a microfinance agency in Georgia exposed the records of more than 1,40,000 of its users to data theft.[50] Thus, it is pertinent that data protection rules protecting individuals be notified. The second issue is the protection of the data and trade secrets of MFIs. It has been found that many MFIs have failed to share adequate data with the credit bureaus as required.[51] This has resulted in insufficient data on the financial health of individual clients with MFIs. Consequently, unaware of whether the borrower already has loans to be serviced, MFIs end up lending to already over-leveraged borrowers. Thus, the disease of over-indebtedness continues to flourish.[52] The primary reason why MFIs fail to share their data with credit bureaus is the lack of trade secret and data protection provisions. Consequently, companies fear that their competitors may be able to access their sensitive data and do not share adequate data with the bureaus. To turn this around, data protection regulation for MFIs is required.

The fourth major concern today is that of consumer protection. While the RBI has introduced the Fair Practices Code[53] and industry bodies have adopted codes of conduct, they are yet to translate into realities.[54] Prohibited practices warranting criminal charges[55] like coercion continue unabated even after a decade since the much-publicized Andhra Pradesh crisis. MFIs have also been primarily blamed for the recent cases of farmer suicides in Maharashtra.[56] This is due to the lack of consumer redressal mechanisms. Even with RBI and

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[48] Nikita Kwatra, *When democracy fails the poor*, LIVEMINT (Oct. 7, 2020), https://www.livemint.com/news/india/when-democracy-fails-the-poor-11602040759209.html; Himanshu, *India's politics and the poor*, ECFR (Oct., 2020), https://ecfr.eu/special/what_does_india_think//analysis/indias_politics_and_the_poor.

[49] Stuart Mills, *How Data Can Win You An Election*, TOWARDS DATA SCIENCE (Aug. 4, 2019), https://towardsdatascience.com/how-data-can-win-you-an-election-3093b0bf76ab; David Lyon & Colin Bennett, *Data-driven elections and the key questions about voter surveillance*, THE CONVERSATION (Aug. 6, 2019), https://theconversation.com/data-driven-elections-and-the-key-questions-about-voter-surveillance-121164.

[50] *Microfinance agency exposes more than 140K user records*, GDPR (Aug. 13, 2019), https://laptrinhx.com/microfinance-agency-exposes-more-than-140k-user-records-1478833326/.

[51] Moin Qazi, *Why microfinance is an ugly word in India's villages*, DAILYO (Dec. 12, 2016), https://www.dailyo.in/politics/mfis-microfinance-village-economy-farmer-suicides-rural-banking/story/1/14582.html.

[52] *Id*.

[53] *Frequently Asked Questions on Non-Banking Financial Company - Micro Finance Institutions (NBFC-MFIs)*, RESERVE BANK OF INDIA (Oct. 12, 2017), HTTPS://M.RBI.ORG.IN/SCRIPTS/FAQVIEW.ASPX?ID=102.

[54] *Self - Regulatory Organization – Background*, MICROFINANCE INSTITUTIONS NETWORK, https://mfinindia.org/our-work/self-regulation/.

[55] ICICI Bank Ltd. v. Prakash Kaur, (2007) 2 SCC 711.

[56] Deeptiman Tiwary, *In 80% farmer-suicides due to debt, loans from banks, not moneylenders*, THE INDIAN EXPRESS (Jan. 05, 2017), https://indianexpress.com/article/india/in-80-farmer-suicides-due-to-debt-loans-from-banks-not-moneylenders-4462930/; *Save farmers from MFI indebtedness*, DECCAN HERALD (Feb. 04, 2019), https://www.deccanherald.com/opinion/second-edit/save-farmers-mfi-indebtedness-716521.html.

industry guidelines, consumers located in remote places with no access to consumer forums fail to benefit. The implication is that consumers have no option to seek redressal against exploitation by the MFIs. Hence, they end up dying by suicide, or seeking help from politicians. This exposes MFIs to political risks and business harms. This issue has further been complicated due to MFIs receiving eligibility to act as Business Correspondents to banks; MFIs can act as intermediaries between banks and consumers, providing financial services of various kinds. In such cases, there is a lack of clarity as to whether the bank or the MFI will be responsible for the breach of consumer rights. Consequently, it is important that regulations providing accessible redressal mechanisms to microfinance consumers and clarifying the responsibilities of Business Correspondents be introduced. A good way to go about this can be to create a Financial Redressal Agency (**FRA**) without any further delay. The FRA was first mooted by the Nachiket Mor Committee in 2013 to address the grievances of retail financial consumers.[57] It will act as a one-stop resolution body for consumers who are otherwise required to go to consumer forums, courts, or banking ombudsmen. Such an agency is required in order to perform the specialized practices required to cater to the needs of financial services customers. For example, an agency like the FRA will be able to deploy village dispute resolution agents, who can provide last mile redressal facilities to clients.

Finally comes the issue of creating a separate regulator for the microfinance sector. The idea of having a separate independent regulator for the microfinance sector has been mooted multiple times.[58] It came close to being implemented twice. First, in the Micro Finance Institutions (Development & Regulation) Bill, 2011, the National Bank for Agriculture and Rural Development (**NABARD**) was given the status of the regulator. Second, in the Micro Units Development and Refinance Agency Bill, 2015, the MUDRA Bank was to act as the sector regulator. Neither of these attempts materialized for reasons unknown, but the need for a specialized regulator for the microfinance sector continues to remain a material demand of the industry.[59] There are several valid reasons for this demand. Microfinance as a sector is currently governed by multiple regulators and bodies, and much has been left to self-regulation. While MFIs, banks, and Regional Rural Banks are governed by the RBI, co-operatives and

[57] Asit Ranjan Mishra, *Govt plans Financial Redressal Agency to address grievances of retail consumers,* LIVEMINT (Dec. 29, 2016), https://www.livemint.com/Industry/HCYiaJJaVGxzIuobEnVKHK/Govt-plans-Financial-Redressal-Agency-to-address-grievances.html.
[58] Aditya Alok and Nihal Joseph, *Regulating the Growing Commercialisation of Microfinance Activities in India,* 5 NUJS L. Rev. 65, 70 (2012).
[59] Mishra, *supra* note 19.

NGOs are governed by the respective state governments.[60] This has led to a lack of uniform regulation. Further, the nature of microfinance differs considerably from regular financial structures. The background of consumers, the geography where microfinance operates, the manner in which services are supplied, the social element and so on require that the regulating agency have specialized abilities. However, it has been argued that creating a new agency will be open to political vagaries and will be time-consuming.[61] Thus, I recommend that the RBI take a balanced approach and create within itself a department solely dedicated to microfinance. Currently, the responsibilities relating to microfinance are shared by multiple departments within the RBI, causing overlaps, confusion and inefficiency. A dedicated department within the RBI would prevent this confusion, without the need to create a new institution.

III. ENHANCING THE SOCIAL IMPACT OF MICROFINANCE

When Grameen Bank was started in Bangladesh, its aim was not just to create financial capital but also to create social capital, both of which work in tandem. It was observed that mandating weekly meetings, where socio-liberal values of life, marriage, family, education, and sanitation were taught and discussed, increased repayment rates considerably.[62] In addition, regular group meetings were important, as they created peer pressure to repay, and acted as a micro-regulatory body to ensure that loans were productively used.[63] The current regulations in India, which focus only on the financial aspect, do not foster such healthy practices. The guidelines provide that repayment may be done weekly, fortnightly, or monthly, as per the choice of the consumer. There is no requirement as to holding and attending mandatory village meetings. Introducing such a provision could be a game-changer for the industry. These meetings, conducted periodically, could become avenues where financial and legal literacy is imparted, and discussions on the best local investment opportunities, negative consumer experiences if any, and so on, can take place. This will bring back the human touch

[60] CUTS CENTRE FOR COMPETITION, INVESTMENT AND ECONOMIC REGULATION, REGULATION OF MICROFINANCE INSTITUTIONS IN INDIA 2 (2013), http://www.cuts-ccier.org/pdf/Regulation_of_Microfinance_Institutions_in_India.pdf.
[61] Richard Rosenberg, *How should governments regulate microfinance?, in* MICROFINANCE EMRGING TRENDS AND CHALLENGES 85, 89 (Suresh Sunderesan ed., 2008).
[62] ALEX COUNTS, SMALL LOANS, BIG DREAMS 25 (2008).
[63] *Id*.

to microfinance, while ensuring that consumers have better information and lenders have higher recovery rates.[64]

The other important measure that can be taken by the government is including microfinance agencies within disaster response plans. Natural disasters, which often impact rural areas more than urban areas, cause heavy destruction to life and property. The people worst affected by such disasters are the poor, who lose their livestock, small businesses, work, and houses. Thus, in post-disaster situations, there is an urgent need for money amongst the poor; they need money to restart their shops and small businesses, buy necessities, and find work. However, credit in such times is scarce and costly. This is where microfinance agencies can play a role in ensuring that people have access to credit, and helping restore rural markets.[65] However, this is easier said than done because of the confusion and lack of facilities after disasters. In such a scenario, if microfinance agencies are included within disaster-response plans, and are given favourable access to disaster-affected areas with the support of relief agencies, it would be a lot easier for people to access credit, and work towards the quick restoration of normalcy.

MFIs too must start working on reducing their cost of borrowing and pass the benefit to people. Currently, they are almost entirely dependent on banks for their funding.[66] This must change with the proliferation of social impact organizations. Today, many donor organizations across the world realize the importance of access to affordable finance. These channels must be tapped into to access cheaper funds. Further, if the idea of Social Stock Exchange, which has been proposed by the government is implemented, it would allow MFIs to come up with social impact projects, which could be listed on the exchange and funds raised to provide low-cost finance to small entrepreneurs and individuals.[67] Apart from helping extend the network of MFIs, such moves will also help with trust-building.

[64] Shayak Sarkar, *Repayment Frequency in the Law of Microfinance*, 31 YALE J. ON REG. 259, 267 (2014); Anand Sinha, *Strengthening Governance in Microfinance Institutions (MFIs) – Some Random Thoughts*, RESERVE BANK OF INDIA (Apr. 23, 2012), https://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/SMFISF270412.pdf.

[65] *Bucks after the Bang: How microcredit can help poor countries after natural disasters*, THE ECONOMIST (Jan. 25, 2018), https://www.economist.com/finance-and-economics/2018/01/25/how-microcredit-can-help-poor-countries-after-natural-disasters.

[66] *Supra* note 10, at 18.

[67] Varsha Aithala, *Idea of Social Stock Exchanges for India*, THE INDIA FORUM (Sept. 22, 2020), https://www.theindiaforum.in/article/social-stock-exchanges-india-sebi-s-promise#:~:text=A%20social%20stock%20exchange%20(SSE,operations%20and%20growth%2C%20and%20reducing.

The Covid-19 pandemic has shown that microfinance cannot be effective on its own.[68] Given the lack of economic opportunities in rural areas, credit disbursed through microfinance cannot be used for productive opportunities by customers. Thus, MFIs must work with other NGOs and governments to offer guidance and training to rural customers to look for alternative economic opportunities.[69] These can include organic farming, sanitation infrastructure building or reforestation services.

However, in the years ahead what will matter the most is scale. One report suggests that "*average all-in cost of borrowing from a small or medium-sized MFI (up to 100,000 clients) is almost 60% higher than the cost of borrowing from a very large one (defined as over 1 million clients). And very large MFIs not only offer customers a better deal, their profit margins are around 2.5 times greater than for small and medium-sized institutions*."[70] Given geographical and infrastructural bottlenecks, increasing scale by simply widening the number of customers may prove unsustainable. Scale must be increased by deepening the quality of customers. MFIs must focus on ensuring that their customers grow financially, become more stable, take bigger loans and pay back on time. This would require MFIs to provide capacity building and value-added services.[71] One Acre Fund, an MFI active in Africa, supplies its members with fertilizers, seeds, agricultural technology, and health essentials on a no-profit model to ensure that they can get the maximum value out of the money it lends them.[72] By doing this, One Acre Fund has not just made its members richer, but has also had positive impacts on agricultural productivity and local economy.[73] This has allowed the fund to scale to over a million farmers, of which 97% repay on time.[74]

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[68] Suvashree Ghosh & Shruti Srivastava, *Millions of defaults threaten microfinance's future in Covid-hit India*, BUSINESS STANDARD (Feb. 4, 2021), https://www.business-standard.com/article/finance/millions-of-defaults-threaten-microfinance-s-future-in-covid-hit-india-121020400429_1.html; For a general understanding on the limits of micro finance, *see* James Roth, *The Limits of Micro Credit as a Rural Development Intervention*, INSTITUTE FOR DEVELOPMENT POLICY AND MANAGEMENT (1997), https://www.gdrc.org/icm/jimmy-roth.pdf.

[69] On the importance of alternative economic opportunities for rural customers, *see* Panos Varangi, *Agriculture Finance & Agriculture Insurance*, WORLD BANK (Oct. 8, 2020), https://www.worldbank.org/en/topic/financialsector/brief/agriculture-finance.

[70] Greta Bull, *After the Storm: How Microfinance Can Adapt and Thrive*, FINDEV (Oct. 15, 2020), https://www.findevgateway.org/blog/2020/10/after-storm-how-microfinance-can-adapt-and-thrive.

[71] INTERNATIONAL FINANCE CORPORATION, SCALING UP ACCESS TO FINANCE FOR AGRICULTURAL SMES POLICY REVIEW AND RECOMMENDATIONS 53 (2011).

[72] *Our Model*, ONE ACRE FUND, https://oneacrefund.org/what-we-do/our-model/.

[73] Silvanus Okumu Opiyo et al., *The Shifting Effect of One Acre Fund on Agricultural Production Possibility Frontier: An Econometrics Analysis of Treatment Effect Estimation of Maize Yield in Busia County, Kenya*, 9(22) JOURNAL OF ECONOMICS AND SUSTAINABLE DEVELOPMENT 124 (2018); Joshua W. Deutschmann et al., *Can Smallholder Extension Transform African Agriculture?* (National Bureau of Economic Research, Working Paper No. 26054, Feb. 2021), https://www.nber.org/system/files/working_papers/w26054/w26054.pdf.

[74] ONE ACRE FUND, ANNUAL REPORT 2019 (2020).

CONCLUSION

The lack of rural credit, which has been touted as one of the primary reasons behind the recent economic downturn, and rising cases of farmer suicides have brought back memories of the 2010 Andhra crisis. These dire circumstances are seen as side-effects of the rise in commercialization of microfinance without due regulations in place. Regulations are needed not only to protect clients but also to facilitate the availability of credit and enhance the societal impact of such funds. Undoubtedly, the RBI has done a lot in the past few years to create a basic framework to regulate the industry. However, as highlighted in the paper, there are a host of legal issues which remain to be addressed. There are existing issues of data privacy, consumer protection, supporting market competition, creating an independent regulator, and so on. As argued, we need a dedicated consumer dispute redressal mechanism for the financial sector. It is also proposed that an independent department within RBI be created to deal with issues relating to microfinance. Further, our regulations should take a principles-based approach to regulating interest rates as against imposing stringent quantitative standards. This will increase the availability of credit, while maintaining the economic feasibility of MFIs. Apart from this, regulators also need to pre-empt emerging issues which may arise due to the rapid digitization of the industry. Further, while access to credit is important, other factors like time, the manner, and the terms of such credit can differ greatly, thereby differently impacting the lives of people. Our regulations should nudge MFIs and other players to maximize the anti-poverty impact of their services. These changes take financial services to areas and people who do not otherwise have access, thereby improving the level of financial inclusion both qualitatively and quantitatively.