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Consumer Protection Regulation

Microfinance Needs and Initiatives in India

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Lack of consumer protection regulation for the Indian microfinance sector lead to a repayment crisis in Andhra Pradesh in late 2010. We examine the salient consumer protection that lead to the crisis, and examine how the 2011 RBI regulation addresses these issues. We also highlight a survey of microfinance institutions, gauging their response to the 2011 RBI regulation. Included is an analysis of consumer protection components of the Micro Finance Institutions (Development and Regulation) Bill 2011, industry associations, regulation used around the world to achieve successful consumer protection policies in the microfinance sector.

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Introduction

Microfinance institutions (MFIs) in India expanded rapidly over the last decade, fueled by capital injection and widespread support that institutions were making a positive impact on the lives of the poor. Though MFIs increased in both size and number, the regulation and oversight of these institutions did not keep pace with the industry. During this phenomenal growth phase Institutions were subject to minimal regulation, particularly with respect to consumer protection.

Larger for-profit MFIs classified as NBFCs were subject to a few prudential regulations, such as capital adequacy ratio standards and minimum capital requirements. Other non-profit institutions, such as NGO-MFIs, Cooperatives, and Section 25s faced almost no regulation other than local or state registration. The Reserve Bank of India (RBI) was responsible for the oversight of NBFCs; however there was no clear authority for institutions of other legal forms.

The for-profit NBFC model for delivering financial services account for over 80% of all lending by portfolio size[i], and were rapidly expanding. Institutions had proved that they could offer financial services, primarily credit, to poor customers and be profitable. The model thus attracted many investors, attracted by profit and social intentions. Private equity funds, international investment groups, development agencies, private donors, and banks flooded the market with capital. Though microfinance institutions operated as NBFCs still held serving the poor and addressing poverty issues as their primary mission, the shareholder structure now held these institutions to achieving profits and sustainable growth as well. As institutions expanded rapidly, many self-admittedly did not address issues like hiring, loan officer training, and customer feedback and interaction adequately.

As a result, clients in Andhra Pradesh stopped repaying microfinance loans to protest the policies and procedures of microfinance institutions. Media focused a few cases of suicides by individuals who were apparently MFI clients, and quickly, customers and politicians claimed that coercive collection practice had lead to the suicide of a number of clients over the last year. Customers also cited high interest rates and predatory lending leading to customer over indebtedness as source for their discontent.

The government of Andhra Pradesh passed the Microfinance Ordinance 2010 in October to respond to these issues. The ordinance restricts microfinance institutions by prohibiting collecting on existing loans and originating new loans until the institution registers with the district authorities where they operate. The ordinance also mandates an interest rate cap, restricts collection practices, and entrusts a great deal of discretionary power to district authorities. The repayment crisis and the state-level ordinance brought a great deal of uncertainty to the national microfinance sector, thus banks and investor quickly stopped the flow of funds to microfinance institutions, putting the solvency of these institutions at risk.

The repayment crisis and the response of the government of Andhra Pradesh brought to light the fact that current regulation did not adequately address consumer protection issues. Many customers felt that they were being abused, and there was no recourse for the customer to complain or hold microfinance institutions accountable to fair practices. In January 2011 the Malegam Committee, a committee appointed by RBI, released a comprehensive set of recommendations for the sector to address all of the regulatory shortcomings. In May 2011 RBI "broadly accepted" their

recommendations, and enacted specific regulation relating to priority sector lending. Later in the summer of 2011, a draft of the Micro Financial Institutions (Development and Regulation) Bill 2011 was released that further addressed regulation issues facing the microfinance sector.

In this paper, we will identify and discuss major consumer protection issues in India prior to the crisis. We look at the existing client protection guidelines and code of conducts that are voluntary in nature and efficacy of such voluntary guidelines. We will then detail how RBI has addressed these issues so far, and gauge the effectiveness of these solutions through a survey of microfinance institutions across India. Our analysis will also cover the consumer protection issues addressed in the Micro Financial Institutions (Development and Regulation Bill 2011. We will then examine global best practices which address similar issues in microfinance sectors in other countries and will conclude with recommendation for addressing the client protection issues.

Consumer Protection Issues

Consumer protection issues in microfinance are being discussed around the world, driven by public concern over high interest rates, coercive collection practices, and irresponsible lending leading to customer over-indebtedness. These debates discuss how intrusive regulation should be when protecting a consumer. One side of the debate suggests that poor borrowers are often financially illiterate and unfamiliar with formal lending practices, and thus need additional protection compared to the formal financial sector. Others think that poor customers should have the right to manage their finances as they see fit, and should not be subject to restrictions such as indebtedness limits.

In this section, we will discuss the major consumer protection issues that lead to the crisis in Andhra Pradesh, including collection practices, over-indebtedness, and high interest rates.

Collection Practices

Collection practices refer to the method in which a microfinance institution collects loan payments from customers. In microfinance, collections predominantly take place in decentralized locations where the loan officers commonly go to a client's workplace or home for collection of periodic installment dues. This method of collection can be more convenient for a customer, since the door-step collection process reduces his opportunity cost for the loan. However, collection at these places can be abused, since the loan officer has significant access to the client's personal life and work environment.

Loan officers all over the world have utilized collection tactics that bring great shame to a client, both in his home and community. Loan officers have also engaged in bullying and physical violence in order to pay loans. Institutions may send individuals to intimidate customers into paying loans through physical threats on the customer or his family in many instances when clients fail to pay their dues. These collection tactics are inappropriate coming from a formal financial institution, and could have consequences that leave the customer in a worse place than before he took the loan and could have severe personal and social consequences.

In the recent past, many news articles and media reports pointed out at instances of abusive collection practices adopted by the loan officers of certain MFIs in India, especially, in the state of Andhra Pradesh

which has the highest microfinance penetration in India. These media coverage had a great deal of impact among the state policy makers and clients in Andhra Pradesh across the country, and resulted in serious round of discussion regarding prevention of abusive collection and recovery practices followed by some officials of the MFIs.

Regulation can include measures to protect customers from inappropriate collection tactics. This regulation can identify specific appropriate or inappropriate collection methods, dictate specifics of collection such as location or timing, or set a system in place that allows customers to identify incidents of inappropriate behavior by loan officers in order to curb these incidences.

Over-Indebtedness

Like any other individuals accepting credit, microfinance clients may elect to be responsible for more credit than they can repay. However, since microfinance is often considered a service aiming to benefit the poor, many policy makers think that institutions and regulation has additional responsibility to ensure that these poor customers do not become over-indebted as a result of easily attainable financing. Arguments also cite that microfinance customers often have less experience dealing with financial institutions and lower levels of financial literacy, and thus require additional protection from over-indebtedness.

Over the past couple of years, the MFIs in India grown rapidly and some of the large commercial MFIs often achieved a very fast growth over a short time period. As a consequence, due to competition and high growth targets, some of the MFIs did not act as responsible lenders and that resulted in over-lending by the MFIs where proper due diligence was not followed while extending the loans to the clients. Frequently, repayment capacity of the borrowers was not taken into account by the loan officers and as a result, multiple MFI loans became widely known phenomena in the highly penetrated areas. This process of irresponsible lending strategies might have fueled client over-indebtedness, and as a consequence, many clients fell into a debt trap as claimed by many stakeholders.

The regulators in India did not put a limit on total indebtedness until recently, when the new RBI regulation in India imposed a total indebtedness limit for microfinance clients.

Opposing arguments suggest that the poor should be able to manage their financial state just like customers in the mainstream financial sector, and thus regulation should not directly impose indebtedness restrictions since it could severely limit their choice.

One option for regulation is to address indebtedness levels directly, as has been done in India. However, this may be difficult to enforce for microfinance clients, where independent indebtedness information is often not available. Regulation may also address regulation over-indebtedness through the creation of credit bureaus or mandating the credit bureau information submission requirements for institutions. Other initiatives to prevent customer over-indebtedness, like financial literacy training, often fall outside of the scope of regulation.

High Interest Rates

Interest rates charged by MFIs are typically much higher than those charged by mainstream commercial lenders, due to the method of credit delivery and the size of loans. The Indian MFIs, in general, charge around 27% interest rate which is much lower as compared to the rates charged by the moneylenders– typically the alternative source of finance for a large majority of the poor population. Regulation can address high interest rates by restricting the interest rate that institutions can charge microfinance clients. This is effective for reducing charges for microfinance clients, but may have unintended negative effects, which will be discussed in the global best practice section.

Enforcement

The greatest challenge with consumer protection issues is enforcement. Though agreement around principles of consumer protection can be agreed upon, such as avoiding consumer over-indebtedness, enforcing related regulation can be a much more difficult issue. Enforcing consumer protection regulation in the Indian microfinance sector, which spans a large number of clients and geographic area, is especially difficult. The two general methods of enforcement are industry self- regulation and government agency enforcement.[ii]

Industry self-regulation is implemented through associations where members agree to adhere to a code of conduct, which details lending best practices, training programs, and review procedures. There are a number of self- regulation associations, such as the Microfinance Institution Network (MFIN) or Sa-dhan. Self-regulation often better reflects the views of microfinance institutions, thus supporting growth and expansion of microfinance services. However, the consequences of not adhering to an association's code of conduct are not that severe, and institutions are barely monitored. In India, expulsion from an industry association occurs on extremely rare occasions, if ever. Additionally, if an institution is expelled from an association, then that association no longer has any authority over the institution.

Government agency enforcement is enacted through state and central legislation. This legislation is often rigid, and has trended towards conservative practices in India in the most recent regulation. Regulation of this kind often applies to all institutions, and can be very costly and difficult to enforce. Regulators may need to form groups to monitor institutions through financial review and regular site visits.

Each approach has advantages and disadvantages, though regulation to address consumer protection issues seems as though it will be enforced primarily through the government lead regulation. Industry associations will continue to exist, both to improve the operations of institutions, and to bind institutions together for expressing their views on government agency enforcement.

In the next section, we will detail how RBI has addressed some of these issues in its most recent regulation, released in May 2011.

RBI Priority Sector Lending

Priority sector lending is a government lead initiative which requires Indian banks to lend approximately 40% of their total portfolio to priority sectors. Microfinance is designated as a priority sector, and thus

banks are incented to lend to institutions offering microfinance services. Historically, although microfinance has attracted approximately only 0.5% of all priority sector funds, commercial banks are the largest sources of finance for MFIs.

Given the importance of the priority sector funds for the survival of the MFIs India, the RBI has strategically chosen to utilize their control over the priority sector funds as a measure to address some consumer protection issues through its most recent priority sector lending qualification circular. This regulation outlines the portfolio requirements a microfinance institution must meet in order to qualify for priority sector lending. This circular was sent to the banks, which offer priority sector funds. Thus, the banks are responsible for enforcing the regulation by ensuring that the microfinance institutions that they lend to meet these requirements in order to be able claim the loans given to the MFIs as priority sector lending. The regulation first creates a new legal category, NBFC-MFI, which is eligible for priority sector funds by meeting requirements. Thus, institutions have the option of not receiving priority sector funds, and not adhering to the regulation.

The requirements state that 75% of a microfinance institution's portfolio must meet a set of requirements. The requirements which relate to consumer protection issues are as follows:

- Maximum loan size of Rs.35,000 (first cycle) and Rs.50,000 (subsequent cycles)
- Maximum borrower total indebtedness of Rs. 50,000
- Minimum tenure of 24 months when loan exceeds Rs.15,000
- No prepayment penalties
- No collateral

An NBFC-MFI must also adhere to the following pricing requirements:

- Margin cap of 12%
- Interest rate cap of 26%
- Only three pricing components
    - Interest rate
    - Processing fee (maximum 1%)
    - Insurance premium
- No penalty for delayed payment
- No security deposit or margin can be taken
- 75% of loan must be for income generating purposes

The RBI regulation addresses over-indebtedness and pricing issues. Over-indebtedness is addressed by restricting loan size, tenure limits, and by restricting customer indebtedness directly. The regulation also addresses customer indebtedness restricting penalties and collateral, so that a customer will not be required to pay more than the initial agreement, or be forced to turn over property. All of these requirements are enforceable by monitoring institutions, with the exception of the direct customer indebtedness limit. MFIs can currently only attain customer indebtedness information by self-reporting

from the customer. Credit bureau licenses for microfinance in India have been issued over the last several years, and these bureaus are working to scale their coverage and functionality.

The current regulation restricts a customer from becoming over-indebted from a single institution; however, a customer can easily become over-indebted by borrowing from other microfinance institutions or sources. The regulation might incent the customer to misrepresent his indebtedness level to qualify for credit.

The 75% of loans for income generating purposes also indirectly addresses over-indebtedness. The regulation presumes that a borrower taking out a loan to invest in a business venture or small enterprise will having greater opportunity to earn income and be able to repay the loan. This regulation aims to deter consumption borrowing, where an individual borrows money for non-income generating activities, such as household purchases, healthcare, or dowry. Again, it will be difficult, if not impossible, for institutions to ensure the use of the loan, since the loan use will be self-reported by the borrower.

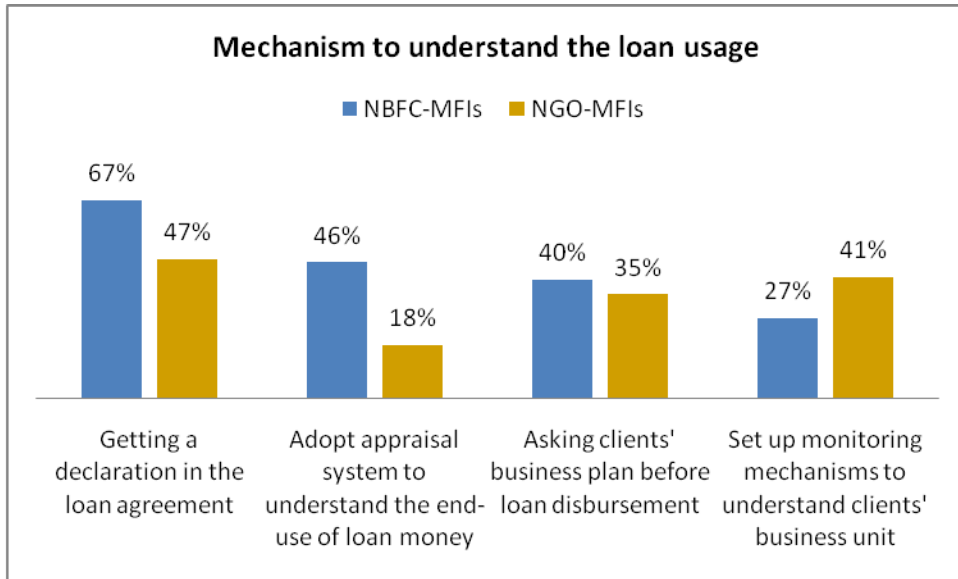
Pricing restrictions are directly applied through a margin and interest rate cap. These caps will be manageable to enforce since enforcement occurs at the institution level. With the interest rate restriction, the RBI has limited other types of charges, and prohibited other forms of charges through penalties or security deposits. This ensures that an institution does not circumvent the margin and interest caps by adding on extra charges in other forms.

Though most of the consumer protection regulation may be enforced, the restrictions may not be the most effective way to ensure consumer protection, particularly if expanding outreach is a priority. In the next section, we will analyze microfinance response to the regulation in regards to consumer protection issues.

Microfinance Institution Response to RBI Regulation

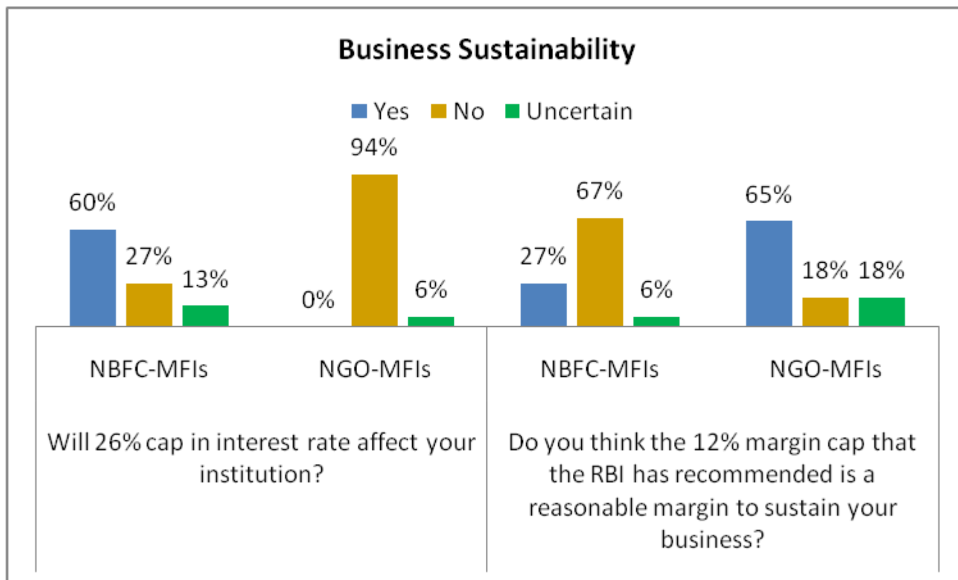
In the summer of 2011, the Centre for Microfinance performed a study[iii] in conjunction with Microfinance Researchers Alliance Program (MRAP) professors to interview microfinance institutions to gauge their response to the new RBI regulation relating to priority sector lending. The study included interviews with 32 microfinance institutions across India, representing NBFCs, Societies, Cooperatives, Trusts, and Section 25s. In this section, we will analyze the microfinance institution responses which relate to customer protection issues.

One section asked how microfinance institutions would ensure that a customer is using a loan for income-generating purposes. The institution could choose from getting a declaration in the loan agreement, adopt appraisal system to understand the end-use of loan money, asking clients' business plan before loan disbursement, or setting up monitoring mechanisms to understand clients' business unit. The graph below shows the results:



The most common answer for both NBFC-MFIs and NGO-MFIs was that they would get a declaration in the loan agreement, which obviously is purely self reported by the customer.

The survey also asked the institutions about how their business would be affected by the margin and interest rate caps. Many of the institutions expressed concern over sustainability of services, particularly for smaller institutions which do not benefit from economies of scale and alternative funding opportunities. The graph below details all the institution responses:



Since the RBI regulation currently only applies to NBFC-MFIs, it makes sense that 60% of NBFC-MFIs think the interest rate cap will affect the institution, while no NGO-MFIs think they will be affected. NBFC-MFIs may need to stop serving rural or harder to reach areas, and may need to target slightly more affluent customers, rather than serving the poorest of the poor. The second question indicates

that a large number of NGO-MFIs would be affected if the margin cap was extended to cover all legal forms.

Though institutions were doubtful about the consumer protection aspects of the regulation, in general they thought that the RBI regulation was good for the sector, and a necessary step towards attaining bank funding.

Micro Financial Institutions (Development and Regulation) Bill 2011

A draft of the Micro Financial Institutions (Development and Regulation) Bill 2011 was released in June 2011, which outlines several new policies that could be put into action. The bill primarily aims to create a comprehensive regulatory framework which would encompass all institutions that provide microfinance services. RBI is designated as the overall regulator for the sector, and RBI's scope and entrusted power is designated in the document. The bill addresses consumer protection in two important ways that are new to regulation of the sector; the power for RBI to force submission of customer information to a credit information service, and a consumer redressal procedure.

The bill briefly mentions the mandatory submission of customer information to credit information service providers by microfinance institutions. The bill does not directly require the submission of information to credit bureaus, but rather gives RBI the power to require microfinance institutions to submit information.

Chapter VII of the bill discusses the consumer redressal procedure. The bill states that RBI, in conjunction with the Micro Finance Development Council and the State Councils, may appoint ombudsmen to facilitate the redressal of grievances between clients of microfinance institutions and microfinance institutions. The chapter further states that RBI will have complete power over the redressal proceedings, including the nature of grievances that can be addressed, and how ombudsmen will conduct themselves and deal with the complaints.

The fact that these two points are included in the bill is positive for the regulatory environment of the sector. However, simply providing RBI the power to address these two points does not ensure that RBI will utilize this power, or if they will execute policies that result in meaningful change for the sector.

Industry Association Codes of Conduct

Consumer protection is also addressed through industry association codes of conduct. Industry associations are a collection of microfinance institutions and microfinance related companies which outline best practices and policies for the sector. The two primary industry associations in India are Sa-dhan and the Microfinance Institutions Network (MFIN). Each of these associations has a code of conduct which every institution belonging to the association agrees to follow. Joining an industry association is voluntary for microfinance institutions, and the enforcement of the code of conduct is primarily through institutions self-regulation.

These codes of conduct outline the spirit of consumer protection for microfinance institutions, however procedures and appropriate practices are not addressed in detail. The MFIN code of conduct is only five pages long, covering the broad areas of fair practices with borrowers, multiple lending and lending limits, data and incident sharing, recruitment, whistle blowing, enforcement mechanism, ombudsmen person mechanism, and amendments to the code of conduct. The Sa-dhan code of conduct is eight pages long, covering even broader categories such as integrity, transparency, and fair practices.

Industry associations are extremely helpful for sharing best practices with other industry players, addressing policy makers, and discussing pressing issues in the microfinance sector. However, since the associations are self-regulation, if an institution conducts inappropriate practices, the only measure the association can take is to expel the institution from the association. Thus, these associations are not adequate for enforcing consumer protection principles in the microfinance sector.

In the next section, we will examine how microfinance regulation and legislation has addressed the issues faced in the Indian microfinance sector.

Global Best Practice

Successful consumer protection regulation bridges the information gap between institutions and consumers. Regulation must protect consumers and allow for expansion of microfinance services, while not imposing excessive costs. In our review of global best practices, we will emphasize redressal procedures and consumer education.

Redressal Procedure

The most impactful and comprehensive consumer protection measure is to give consumers a method for complaint and redressal. When consumers are given a voice, no matter what the problem or issue, regulators and institutions will become aware and have an opportunity to address the issue before it escalates to a crisis. For a redressal procedure to work, regulators and institutions must adequately address the complaints of consumers. If complaints are made, but not addressed, then consumers will quickly lose faith in the redressal system.

Peru is an example of a country that has implemented a successful consumer protection policy. In Peru, the financial regulatory authority puts policies and procedures in place regarding how institutions receive, manage, and resolve consumer complaints. In 2008, approximately 99% of 400,000 consumer complaints were handled by this financial regulatory authority. Consumers may also take their complaints to the courts, the banking association’s financial ombudsman, or a consumer protection agency. Peru combines these opportunities with adequate supervision and financial literacy campaigns and projects. Off-site supervision of institutions assures that relevant and adequate information is disclosed. As a result of these policies, consumer complaints dropped by 32% since 2004.

Malaysia also focuses heavily on consumer education and response to consumer complaints. Financial information is disseminated to schools, community groups, and through various media sources to develop financial literacy. Financial institutions are required to have a complaints unit, with services

targeting youth, involvement of the financial industry, credit counseling, and debt resolution. The central bank also receives complaints and offers advice.

Currently in India, the CPA has specified a redressal mechanism where quasi-judicial bodies can hear and resolve disputes at the national level, state level, and even district level. One option is to expand this redressal mechanism to cover microfinance services, so that microfinance customers will have the option to settle formal disputes with institutions.[iv]

Over-Indebtedness

Global best practice demonstrates that the best way to prevent client over-indebtedness is through the implementation of a credit bureau. The great majority of countries believe that credit reference services would improve conditions for both customers and institutions. However, regulation will determine what is required for these bureaus. Some countries require financial institutions to submit customer information. Peru initially required submission of information on borrowers with loan amounts greater than US $5000, which excluded microloans. However, regulation was later amended so that customer information is required to be submitted for all loans. Thus, institutions can check for credit history when extending a microloan. Giving institutions access to a customer's current indebtedness will allow microfinance institutions to make better decisions as to whether to extend credit and in this way, mandating information sharing could strengthen the responsible finance initiatives.

Interest Rate Restrictions

Interest rate caps, though intended to protect the poor, often results in a reduction of financial services to the poorest of the poor and to those in rural areas. The costs of making very small loans and servicing rural areas is greater than making larger loans and servicing more urban areas, thus when an interest rate cap is implemented, microfinance institutions in many countries have reduced these services to maintain profitability. Interest rate caps can also result in less product transparency, since institutions may try to add charges or penalties that make it more difficult to understand product risk.

When an interest rate cap of 27% was implemented in South Africa, institutions immediately withdrew from rural areas and focused on less expensive areas to serve. Nicaragua's microfinance institutions' portfolio growth fell to 2% from 30% annual growth when an interest rate cap was introduced in 2001.[v]Table 1 shows the interest rate changes, and the implications for microfinance loans as well as loans in developed countries.

Interest Rate Caps			
Jurisdiction	**Date**	**Nature of Change**	**Reason for Change and Implication**
Columbia	2006 (effective 2007)	Ceiling (34%) for microloans higher than the general ceiling	Higher ceiling to encourage microcredit. Implementation of the new ceiling has not occurred, microfinance portfolios and institutions still expanding[17]
West Africa	1990s	27% Ceiling	MFIs immediately pulled out of rural areas, and

			increased average loan size. Eventually found ways to circumvent with fees.
Nicaragua	2001	The Central Bank publishes interest rate every month	Growth decreased to 2% annually to 30% annually. Several MFIs pulled out of rural areas.

Table 1[vi]

Recommendations and Conclusion

Our recommendations are split into short-term and long term recommendations. Short term should are regulations to be implemented immediately, that will draw both immediate and long term benefits for consumer protection issues. Long-term recommendations should be implemented after certain aspects of consumer protection have improved.

Short-Term Recommendations

1.) Require microfinance institutions to submit information to a credit bureau. A comprehensive database of microfinance credit information may never be complete if institutions submit information voluntarily.
2.) Create standard legislation or regulation which details inappropriate collection and lending practices. This should set well-defined standards for the sector so that institutions can understand their limitations, and industry associations can help with enforcement.
3.) Remove the interest rate and margin restrictions. This restrictions will not allow institutions to expand outreach to many unserved regions and the poorest of the poor.

Long-Term Recommendations

1.) Require institutions to check a client's credit information with the credit bureau before offering credit or other financial services which result in client liability.
2.) Implement a comprehensive redressal procedure for microfinance clients to enforce inappropriate collection and lending practices. Allow clients to air grievances at block or district courts to settle disputes with MFIs regarding lending practices, operations, and fraud. Require institutions of appropriate size to have a staff member or team dedicated to dealing with customer grievances.

Conclusion

Ultimately all policy makers and regulators want to adequately protect the customer, while providing them the benefits of access to credit and other financial services. However much debate surrounds how to achieve this goal and what tradeoffs should be made between expansion of services, customer protection, and institutional requirements.

Collection practices, high interest rates, and over-indebtedness have proven to be the most salient customer protection issues in India for microfinance clients. A recent draft of the Micro Finance Institutions (Development and Regulation) Bill 2011 addresses some of these issues, notably giving the regulator the power to require institutions to submit their information to credit reference services

providers and the power to create a grievance redressal procedure for microfinance clients. However, this legislation will be passed at the end of 2011 at the earliest, and RBI may not elect to use the power granted to them by this bill.

RBI has addressed consumer protection issues in their most recent regulation, however some aspect of their approach will be difficult to implement, and do not always represent global best practice. After the crisis in Andhra Pradesh, many are relieved to see any regulation that addresses consumer protection issues. As time progresses, regulation can be refined and amended to best allow for customer protection and expansion of microfinance services in India.

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