Should NABARD be Micro Finance Regulator?

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NABARD is a key participant in the microfinance sector and has been closely associated with one of the two prevailing modes i.e. SHG-bank linkage mode of delivery of microfinance services. The developmental role envisaged in the Microfinance Bill for this institution will further strengthen its role as service provider. Combining the role of service provider and regulator is not good governance practice as it could lead to serious conflict of interest.

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The debate subsequent to the introduction of the recent Micro Financial Sector (Development and Regulation) Bill, 2007 (henceforth the Bill) reveals that there is broad consensus that the sector needs to be regulated. But who should regulate the sector?

The above question was addressed by the Consultative Group to Assist the Poor (CGAP), an international consortium of 33 public and private development agencies in 2002 (www.cgap.org). Subsequently, the micro finance consensus guidelines were evolved which have been adopted by CGAP's donor agencies.

The guidelines recommend that as far as possible the regulation should be focused on the type of transaction and not the type of institution undertaking it. They also favour a clear distinction between the supervision of depository (deposit accepting) and non-depository MFIs (micro finance institutions). The need for regulation and supervision is greater for those MFIs which are authorized to accept deposits as they pose a greater risk to their members and to the financial system.

The CGAP guidelines recommend that for depository MFIs, the supervisory body most appropriate would be the authority which supervises commercial banks. This leverages existing supervisory skills. It further reduces incentive for regulatory arbitrage, namely, structuring operations in such a manner that the organization comes under the jurisdiction of a weaker regulator. The supervisory staff of the regulator, however, must be retrained to suit the different portfolio characteristics of MFIs.

Another alternative suggested for supervision of depository MFIs is "delegated supervision", which refers to an arrangement where the banking regulator delegates direct supervision to an outside body while monitoring and controlling the delegated body's operations.

Consistent with the CGAP guidelines, in addition to effectiveness and cost of supervision, the socio-economic and regulatory context of India must be considered in deciding on the regulator for the micro-finance sector.

Before considering the choice of regulator in the Indian context, clarity is needed about whether the Bill attempts to regulate the microfinance sector as a whole, or whether it seeks to enable particular institutional forms of MFIs to offer savings services under the supervision of the regulator.

If the Bill intends to regulate the sector as a whole, it needs to bring under its ambit the entire range of participants in the sector including banks, non-banking financial companies (NBFCs), section 25 companies (Not for profit companies), non government organizations (NGOs) societies, trusts and cooperatives. The Bill should set ground rules for all participants with regard to their micro finance activity. However, if its objective is to permit MFIs to accept deposits, then it needs to only register and regulate MFIs intending to do so.

Any analysis of the Bill is complicated by the fact there is ambiguity with regard to its scope. The Bill defines a micro finance organization (MFO) as 'including' societies, trusts and cooperatives, leading to varying interpretations. One possible interpretation is that the Bill does not include in its scope legal forms other than those mentioned. This implies that NBFCs and Section 25 companies are excluded from its scope. Another possible interpretation is that the definition of MFO given in the Bill is not an exhaustive one and hence the Bill does, in fact, cover NBFCs and Section 25 companies.

The provisions of the Bill concerning the regulator for the micro finance sector in India are inconsistent with the CGAP guidelines. The Bill designates the National Bank for Agricultural and Rural Development (NABARD) as the single regulator for both depository and non-depository micro MFOs, while the guidelines suggest separate regulators for each. According to the guidelines, in the Indian context, the Reserve Bank of India (RBI) should regulate depository MFIs, as it already regulates banks and NBFCs. An option worth considering is to create a special category of NBFCs which would be suitable for the deposit taking MFIs.

Those advocating the Bill's choice of NABARD as regulator must provide convincing reasons for departing from the CGAP guidelines. Also, NABARD is a key participant in

the microfinance sector and has been closely associated with one of the two prevailing modes ie.SHG (self help group)-bank linkage mode of delivery of microfinance services in the country. The other is the MFI mode. The developmental role envisaged in the Bill for this institution will further strengthen its role as service provider. It is widely recognized that combining the role of service provider and regulator is not good governance practice as it could lead to serious conflict of interest.

NABARD also lacks expertise to regulate and develop MFIs in the urban sector as its role has been confined to rural areas and to agriculture. With India urbanizing at a rapid rate, urban poverty as a public policy issue is becoming more prominent, leading to increased interest in urban micro-finance.

The issue of regulatory arrangements for insurance and pension services offered by the MFOs is not addressed in the Bill. Insurance services in India are regulated by the Insurance Regulatory and Development Authority (IRDA), and the pension services are proposed to be regulated by the Pension Fund Regulatory and Development Authority (PFRDA). In the accumulation phase of the micro-pension schemes involving investment of pension savings, asset management companies are likely to be involved. These are currently regulated by SEBI (Securities and Exchange Board of India).

At the minimum, this suggests a strong need for coordination among regulators of different financial and capital market institutions. As the barriers among different financial service providers come down, the role of specialized regulators will require reconsideration in the medium term.

The need for efficient regulatory capacity building for the microfinance sector is important for financial inclusion and for providing confidence to customers and investors in the sector. The regulation of the sector requires more extensive consultations and public debate than is reflected in the Bill.

The above considerations strongly suggest that the Bill's choice of NABARD as the micro finance regulator requires reconsideration.