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Self Regulatory Organizations in Indian Microfinance Sector

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Abstract

Introduction of Micro Finance Institutions (Development and Regulation) Bill, 2012 is a land mark in the history of Indian Microfinance Industry. This bill aims to provide for the development and regulation of microfinance institutions in India. One of the salient features of this bill is that all NBFC-MFIs must be members of at least one self-regulatory organization (SRO) recognized by the RBI and comply with the code of conduct prescribed by the SRO. Even though the introduction of the Microfinance bill is a bit late, all the stakeholders appreciated and welcome the move of the Government.

The microfinance industry in India is highly distributed and has many small players. The Reserve Bank of India (RBI) has limited presence on the ground. As the MFIs have businesses in the hinterland, there is a need for self-regulatory organizations (SROs) to enforce some self-discipline in the sector. An SRO is a voluntary body appointed by the industry participants to monitor the functioning of all players in the industry and bring in some degree of standardization in industry practices. These organizations operate under the overall regulatory supervision of the main regulator and help the main regulators in accomplishing their regulatory objectives. This mechanism provides an effective and efficient form of regulation in the constantly changing business environment because SROs virtually strive to strike an intelligent balance between the interest of its members and their regulatory responsibilities delegated by the main regulators. So, an SRO for microfinance institutions will play a complementary role to the Reserve Bank of India. Normally, this kind of entities knows the industry best and in many ways has the understanding, knowledge and ability to recognize a problem before it becomes too big.

The authors made an attempt in this paper to provide a conceptual understanding on self-regulatory organizations (SROs), their functions and benefits, give clarity about SROs in Indian financial system in general and in Micro Finance Sector in particular. This paper also highlights the issues to be handled by RBI, while designing the policy frame work for SROs. Also focuses on contemporary challenges for self-regulatory organizations with a view to enable them to formulate strategies to overcome.

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1. INTRODUCTION

The microfinance sector in India has gone through turbulent times for the last few years. The southern state of Andhra Pradesh, the biggest market for the country's microfinance institutions, was at the center of the storm, and populist moves by politicians led to mass default of loans. Operations are almost come to a standstill. The Central Government has stepped in and introduced t*he* Micro Finance Institutions (Development and Regulation) Bill, 2012 in the Lokhsabha on May 22, 2012. The Bill seeks to provide a statutory framework to regulate and develop the micro finance industry.

This Bill seeks to empower the Reserve Bank of India (RBI) to specify the maximum limit of the margin and annual percentage rate that can be charged by an MFI. It also seeks to prohibit MFIs from carrying on the activities of micro-finance services without registration with the RBI. The Bill provides for the constitution of a microfinance development council to advise the Central Government on policies, schemes and other measures required to be taken in the interest of orderly growth and development of MFIs. The Bill also seeks to empower the RBI to specify sector-related benchmarks and performance standards pertaining to methods of operation, fair and reasonable methods of recovery of loan advanced by MFIs. The RBI is also proposed to be empowered to set up a microfinance development fund to be applied for providing loans, grants or seed capital as also for training of personnel engaged in micro-finance institution services.

Another salient feature of this bill is that all NBFC-MFIs must be members of at least one Self-Regulatory Organization (SRO) recognized by the RBI and comply with the Code of Conduct prescribed by the SRO. Guidelines for the recognition of SROs will be notified soon. SROs will play a key role in ensuring compliance with the regulatory framework.

In the light of above developments, the authors made an attempt in this paper to provide a conceptual understanding on self-regulatory organizations (SROs), their functions and benefits, give clarity about SROs in Indian financial system in general and in Micro Finance Sector in particular. This paper also highlights the issues to be handled by RBI, while designing the policy frame work for SROs. Also focuses on contemporary challenges for self-regulatory organizations with a view to enable them to formulate strategies to overcome.

2. SELF-REGULATORY ORGANIZATION (SRO)

A Self-Regulatory Organization (**SRO**) is a voluntary, member-driven organization that sets its own rules for fair conduct, licenses or approves firms engaging in market making activities, and supervises the activities of market participants and enforcement of rules of conduct for fair, ethical and efficient practices.

Self-Regulatory Organizations are typically the organizations created by the industry players. But, they perform the functions much beyond that of an industry association, which is merely an interface between the industry and the regulators and other government bodies for propagating the industry benefits. These organizations operate under the overall regulatory supervision of the main regulator and help the main regulators in accomplishing their regulatory objectives. For all practical purposes, SROs become the first level regulators and so the major tool for proliferation of the disciplinary culture among the industry players.

Markets, across the world, are undergoing remarkable, unexpected, and swift changes. Technology and information explosion has contributed a lot for the way the markets are operating today. So, there is a need to regulate these markets and it is the responsibility of the regulator. But one cannot leave everything to the regulators. Hence, it is believed that the development of the SROs is undoubtedly a wise strategy to improve the effectiveness of markets and market integrity.

Different markets across the globe have developed the SROs in the different formats based on the prevailing practices in those markets. It is to be mentioned that Self regulations exists before the statutory regulation came into force in various sector across the globe. But the fact is that execution of self-regulations by the Self-Regulatory Organizations was not remarkably well.

Self-Regulatory Organizations generally include exchanges, associations, depositories, etc. Examples of prominent SROs across the globe are the National Association of Securities Dealers (NASD) and National Stock Exchanges such as the NYSE in the United States, or the Investment Dealers Association (IDA) in Canada. The American Arbitration Association (AAA) and American Medical Association (AMA) are examples of effective SROs in other industries that set performance standards, protect member interests, and seek to strengthen their respective fields.

3. GENERAL FUNCTIONS OF SELF-REGULATORY ORGANIZATIONS

Some of the general functions to be performed by the Self-Regulatory Organizations in the field of Microfinance are as follows

1. Provide membership to all the Microfinance Institutions operating in the country, which satisfy the criteria evolved by them.
2. Providing an enabling environment for the enhancement of Microfinance activities.
3. To facilitate the adoption of best practices within the sector and establish rules those are fair and based on stability and efficiency principles.
4. To build the sectoral capacity in Microfinance sector. For this purpose, SROs pool together expertise towards common purposes such as increasing efficiency, productivity, improving systems, procedures and practices.

5. To promote robust development of microfinance sector by encouraging responsible lending to the clients from MFIs and such other good practices.
6. Protecting the interests of its members.
7. Operate under the overall regulatory supervision of the main regulator and help the main regulators in accomplishing their regulatory objectives.
8. Maintain a balance between the interest of its members and their regulatory responsibilities delegated by the main regulators.
9. Working towards structuring a comprehensive microfinance industry Information Hub with the objective of supporting policy formulation/dialogue and guiding industry practices.
10. Project good public image towards the industry and develop good public relations.
11. Provide a formal grievance redressal mechanism for its members.

4. BENEFITS FROM THE SROs :

Self-Regulatory Organizations (SROs) provide the following benefits:

1. **Comprehensive Knowledge about the Industry:** Self-Regulatory Organizations are typically the organizations created by the industry players. Their interaction with their members, regulators, markets, other players in the industry and Government on day to day basis made them to gain specialized knowledge about the industry.
2. **Industry Motivation:** One of the functions of an SRO is to project good public image towards the industry and develop good public relations. Being the part of an SRO, the members of the organization will automatically get good image in the minds of the stakeholders of the industry.
3. **Flexibility in regulations:** SROs normally operate under the overall regulatory supervision of the main regulator and help the main regulators in accomplishing their regulatory objectives. SROs interaction on day to day basis with main regulator helps the regulations being more dynamic and market oriented.
4. **Lower cost of regulation:**The microfinance industry in India is highly distributed and has many small players. The Reserve Bank of India (RBI) has limited presence on the ground. Executing statutory regulations on the activities of so many small MFIs disbursed in a wider geographical area becomes an expensive exercise. So, there is a need to enforce some self-regulation in the sector. Self-regulation is less costly than the statutory regulation.
5. **Best practices:** SROs by and large facilitate the adoption of best practices within the sector and establish rules that are fair and based on stability and efficiency principles. These practices enable the members to increase their efficiency, productivity; improving systems, policies and procedures.
6. **Information hub:** Another major function of an SRO is that it collects, classify, compile and circulate statistical and other information pertaining to the industry. An SRO in the field of Microfinance is simply an Information hub. The information collected, complied and processed by an SRO is not only useful to the members to formulate their own strategies but it is also useful to the regulators in formulating the policies, strategies suitable to the markets.

5. SELF-REGULATORY ORGANIZATIONS IN INDIAN FINANCIAL SYSTEM

Self-regulatory Organization is not at all a new concept across various industries in India. Some of these organizations have been evolved on voluntarily and others are established intentionally by the regulators. Some of the prominent Self-Regulatory Organizations functioning in India Financial System are as follows:

a) Indian Banks' Association (IBA)

Indian Banks' Association (IBA) is a voluntary service organization of the banking industry in India. It was formally established on 26thSeptember 1946 with 22 members. As on 31stMay 2011, IBA had 161 members. It represents various constituents of banking and finance industry covering public sector banks, private sector banks, foreign banks, urban co-operative banks. Reflecting the growing complexity of finance, the Association's role has expanded, from assisting member banks with their activities, to function as a self-regulatory organization and as an effective liasioning agency between the industry and authorities and preparing the members to adapt themselves to the changing times.

b) Association of Mutual Funds of India (AMFI)

With the increase in mutual fund players in India, a need for mutual fund association in India was generated to function as a non-profit organization. Association of Mutual Funds in India (AMFI) was incorporated on 22nd August; 1995.AMFI is an apex body of all Asset Management Companies (AMC) which has been registered with Securities and exchange Board of India (SEBI). Till date all the AMCs are that have launched mutual fund schemes for the benefit of its members. AMFI functions under the supervision and guidelines of its Board of Directors. Association of Mutual Funds India has brought down the Indian Mutual Fund Industry to a professional and healthy market with ethical lines enhancing and maintaining standards. It follows the principle of both protecting and promoting the interests of mutual funds as well as their unit holders.

c) Advertising Standards Council of India (ASCI)

The Advertising Standards Council of India (ASCI) founded in 1985. The three main constituents of advertising industry viz advertisers, advertising agencies and media came together to form this independent Non-Governmental Organization (NGO). The aim of ASCI is to maintain and enhance the public's confidence in advertising. Their mandate is that all advertising material must be truthful, legal and honest, decent and not objectify women, safe for consumers - especially children and last but not the least, fair to their competitors. There is no other non-governmental body in India which regulates the advertising content that is released in India. In 1985, the ASCI adopted a Code for Self-Regulation in Advertising.

d) Association of Investment Bankers of India (AIBI)

In the early 1990s, the merchant banking industry in India witnessed a phenomenal growth with over 1500 merchant bankers registered with SEBI. In order to ensure the well being of the industry and for promoting healthy business practices, it became necessary to set up a Self-Regulatory Organization within the industry. This led to the birth of the Association of Investment Bankers of India (AIBI). AIBI was promoted to exercise overall supervision over its members in the matters of compliance with statutory rules and regulations pertaining to merchant banking and other activities. AIBI was granted recognition by SEBI to set up professional standards, for providing efficient services and to establish standard practices in merchant banking and financial services. AIBI, in consultation with SEBI, is working towards improving the compliance of statutory requirement in a systematic manner. AIBI's primary objective is to ensure that its members render services to all its constituents within an agreed framework of ethical principles and practices. It also works as a trade body promoting the interests of the industry and of its members.

e) Foreign Exchange Dealers Association of India (FEDAI)

Foreign Exchange Dealers Association of India (FEDAI) was set up in 1958 as an Association of banks dealing in foreign exchange in India (typically called Authorized Dealers - ADs) as a self-regulatory body and is incorporated under Section 25 of The Companies Act, 1956. Its major activities include framing of rules governing the conduct of inter-bank foreign exchange business among banks vis-à-vis public and liasion with RBI for reforms and development of FOREX market.

Due to continuing integration of the global financial markets and increased pace of de-regulation, the role of self-regulatory organizations like FEDAI has also transformed. In such an environment, FEDAI plays a catalytic role for smooth functioning of the markets through closer co-ordination with the RBI, other organizations like FIMMDA, the FOREX Association of India and various market participants. FEDAI also maximizes the benefits derived from synergies of member banks through innovation in areas like new customized products, bench marking against international standards on accounting, market practices, risk management systems, etc.

f) Financial Planning Standards Board India (FPSB)

Financial Planning Standards Board India (FPSB) is a public-private enterprise and a Professional Standards Setting body that proactively guides the development and promotion of standards for Financial Planning professionals to benefit and protect the public in the country. FPSB India closely works with all the stakeholders' viz. the Government, the Regulators, the Industries/Associations, the Corporate, the Media and the General Public to achieve its objectives. It is a Professional Membership & Certification organization-part of leading Global Confederation established by prominent financial service corporations with an objective to professionalize the concept of Financial Planning in India. FPSB India is based on voluntary Self-Regulatory Mechanism, which is reflected by virtue of its Code of Ethics & Rules of Professional Conduct, which is mandated for all its members. As a professional voluntary Self-Regulatory Organization, FPSB India promotes and maintains voluntary standards of professionalism including Education, Examination, work Experience and Ethics requirements and will continue to co-operate the Government, Regulators and other agencies to appropriately, effectively and uniformly regulate personal Financial Planning practitioners.

g) Data Security Council of India (DSCI)

Data Security Council of India (DSCI) is a focal body on data protection in India, setup as an independent Self-Regulatory Organization (SRO) by NASSCOM, to promote data protection, develop security and privacy best practices & standards and encourage the Indian industries to implement the same.

DSCI is engaged with the Indian IT/BPO industry, their clients worldwide, Banking and Telecom sectors, industry associations, data protection authorities and other government agencies in different countries. It conducts industry wide surveys and publishes reports, organizes data protection awareness seminars, workshops, projects, interactions and other necessary initiatives for outreach and public advocacy. DSCI focused on capacity building of Law Enforcement Agencies for combating cybercrimes in the country and towards this it operates several Cyber labs across India to train police officers, prosecutors and judicial officers in cyber forensics.

Public Advocacy, Thought Leadership, Awareness and Outreach and Capacity Building are the key words with which DSCI continues to promote and enhance trust in India as a secure global sourcing hub, and promotes data protection in the country.

6. SELF-REGULATORY ORGANIZATIONS IN MICROFINANCE SECTOR:

Existence of SRO for implementation of self regulation among MFIs is not a mandatory requirement in Microfinance Industry in India until introduction of Microfinance bill. But, there are certain industry Associations which came forward to take up the responsibilities of an SRO. At present, there are two biggest industry associations in India viz. Sa-dhan and Microfinance Institutions Network (MFIN) perform the functions of SRO on voluntary basis in Indian Microfinance Industry. Both of these associations offer a great deal of resources, guidance, and forums for institution discussion so that the most pressing issues facing the industry can be collectively addressed.

1. Sa-Dhan

Sa-Dhan's mission is to build the field of community development finance in India to help its member and associate institutions to better serve low-income households, particularly women, in both rural and urban India, in their quest for establishing stable livelihoods and improving quality of life.

Founded as the Association of Community Development Finance Institution by SEWA Bank, BASIX, Dhan Foundation, FWWB, MYRADA, RGVN, SHARE and PRADAN in 1999. Sa-Dhan's membership has now grown to 251 with the collective loan outstanding and outreach in excess of Rs. 18,343 crores and 26.7 million poor, respectively.

The Microfinance sector in India is still evolving and witnessing increasing entry of new players. Hence Sa-Dhan as the designate national association of Community Development Finance Institutions (CDFIs) represents an "emerging but rapidly growing sector". Given the nascent nature of the sector, Sa-Dhan has a crucial role to play in increasing capacities, affecting the evolution and adoption of best practices, increasing the number of service providers and contributing to improving the policy and operational context for Microfinance in India.

2. Microfinance Institutions Network (MFIN)

Microfinance Institutions Network (MFIN) is a primary representative body and the Self-Regulatory Organization (SRO) for Non-Banking Finance Companies (NBFC) Microfinance Institutions (MFIs) regulated by the Reserve Bank of India (RBI). Microfinance Institutions Network (MFIN) was established in October 2009 as a Society under the Andhra Pradesh Societies Registration Act 2001. MFIN currently has a membership of 42 NBFC MFIs.

MFIN was created to promote the key objectives of microfinance, which is to help economically underserved communities achieve greater financial independence and build sustainable livelihoods. MFIN seeks to work closely with regulators and other key stakeholders to achieve larger financial inclusions goals through microfinance. The core areas of work for MFIN are Self-Regulation, Policy Advocacy and Development. MFIN has facilitated setting up a database of the borrowers which confirms the necessary validation required. The database consists of over 30million micro borrowers and about 60 million loan accounts. When a person applies for the loan, MFI checks for the loan history and verifies the RBIs benchmark with the credit reports. The credit reports are 80-90% accurate. MFIN is solely member funded and its Governing Board is elected from amongst the leadership of its member MFIs.

7. ISSUES BEFORE THE RESERVE BANK OF INDIA.

Micro Finance Institutions (Development and Regulation) Bill, 2012 empower the Reserve Bank of India (RBI) as main regulator for the Indian Microfinance Sector. Guidelines with regard to SROs are yet to be finalized and notified. But the fact is that SROs are being created to share the responsibilities with the main regulator. Further, as mentioned before, in global markets there is no specific structure of these SROs and they have evolved differently in the different markets. So, there are certain issues to be resolved by the Reserve Bank of India with regard to SROs in the process of finalizing guidelines.

1. **Eligibility criteria to become an SRO:** Reserve Bank of India must specify the eligibility criterion for being registered as Self-Regulatory Organization (SRO) in terms of its nature of registration of the firm, financial status, manpower requirements, composition of director's board, infrastructure, age of the organization, minimum number of members at the time of registration and other such conditions.

2. **Mode of registration:** How the RBI is going to provide registration to the firms need to be clarified. Is it a 'first come first serve' basis kind of registration or extend registration to all those who approach RBI or the RBI invite application from all eligible SROs or call for sealed tenders from all those SROs, which satisfy the set norms.

3. **Terms of Registration:** RBI has to provide clarification with regard to terms of registration such as is it 'one time registration in the entire life of the SRO' or for a specific period i.e., for 5 years or 3 years. If the registration is for a specific period how the renewal takes place; whether renewal is automatic or based on the performance review.

4. **Fee for registration:** Micro Finance Institutions (Development and Regulation) Bill, 2012 clearly stated that all NBFC-MFIs need to be registered with the Reserve Bank of India (RBI). Is there any amount of fee to be paid by an SRO for registration or is it for a free of cost. If some amount of fee is to be paid for the registration, for renewal of SROs with RBI, the exact amount need to be finalized. Moreover, clarity is also required with regard to amount of fee to be charged at the time of initial registration with RBI.

5. **For Profit or Non-profit:** RBI has to decide whether the SROs should be a profit oriented organization or non-profit organization. To protect the interest of the stakeholders, it is believed that non-profit kind of structure is always good. If the SROs is registered as a profit oriented 1organization, it is argued that there is a possibility of dilution of standards in pursuit of profit. As a balanced decision, the RBI may be silent about this aspect and leave this issue to the stakeholders to decide.
6. **Membership in SROs:** With regard to the membership in SROs, Micro Finance Institutions (Development and Regulation) Bill, 2012 made it clear that before register with the Reserve Bank of India, it would be mandatory for MFIs to be the member of any of the recognized SROs in the Microfinance Sector. The RBI has to clarify nature of MFIs that they are going to consider and recognize, because MFIs vary widely with regard to their nature, operations, powers, registration in Indian Microfinance Sector. Whether SROs are permitted to provide membership to Self Help Groups (SHGs) in SROs also another notable issue to be clarified.
7. **Framework for SROs' operations:** Clarity is required from the RBI front with regard to frame work for SROs operation such as formulation of Memorandum of Association, Articles of Association, By-laws and other rules & regulations, guidelines etc. At every point in time, SROs would ensure that their rules/regulations and guidelines are consistent with the policy framework created by RBI. Accordingly, they would be required to carry out changes in their regulatory framework in view of the changes taking place in the main regulations.
8. **Management of SROs:** Reserve Bank has to give clarity with regard to management of SROs. If the SROs need to function with group of people at the top, name and nature of the group viz., Board/Committee has to be clarified. If the SROs need to constitute a Board, the composition of Board, appointment of independent directors, quorum for the meetings, powers of the directors etc., need to be specified.
9. **Functions to be performed:** What should be the role of SROs? In the scene that the functions performed by SROs need to be clarified. In addition to the functions stipulated by the regulator, SROs perform certain general functions, which include, provide membership to the MFIs, build up the image of the industry, act as an intermediary for MFIs, the RBI and Government, establishing code of conduct, comply with norms set by the regulator, establish grievance redressal mechanism, collects, classify and circulate statistical and other information pertaining to the Industry etc.
10. **Disciplinary action:** What should be the powers of SROs in the process of dealing with indiscipline on the part of its members? Whether, the SROs are allowed to take action against the erring members or it has to recommend it to the RBI to initiate the action against the members who violate prescribed code of conduct or for any malpractice.
11. **Controls:** The relationship between RBI and the SROs need to be clarified. The RBI has to decide the kind of control to be exercised over SROs. Normally, the SROs are expected to comply with the norms prescribed by Reserve Bank of India. Further, they would need to submit different kinds of reports prescribed by the regulator at regular intervals. The frequency and the format of the report would be a dynamic phenomenon, depending on the needs of time, and would be decided by the RBI in consultation with the respective SROs. In addition to this, RBI has to specify its authority to take a direct action against the office bearers of the SROs or their members.

8. CHALLENGES FOR SROs IN MICROFINANCE SECTOR IN INDIA.

1. **Conflict of Interest:** First and foremost challenge before the SROs would be conflict of interest. As SROs are created by industry participants and operate as regulators under the auspices of the main regulator, striking balance between the members' interest and market's interest (delegated by regulator) becomes a major challenge for them. Any wrong action tilted in favor on the members may endanger the SROs' credibility. Further, conflict of interest may arise because of the representation of the members on the board and disciplinary committee of the SROs, which have the power to initiate the action against the members. Inequality of the treatment among the members of the SRO may also be a potential conflict situation.
2. **Uneconomical proposition:** Establishing and maintaining an SRO is going to be a hercules task, because of large number of small and varied, financially weak Micro Financial Institutions operating in the country. Close monitoring, recording, maintaining and controlling the activities of large number of MFIs by collecting merger membership fee is certainly difficult task for an SRO from the cost perspective.
3. **Building trust and confidence:** In the light of recent crisis in Indian Microfinance Industry, building trust and confidence of the stake holders such as bankers, investors, clients, regulators etc. in Microfinance Industry in India would be the biggest challenge for the Self-Regulatory Organization.
4. **Developing innovations in products/services, operations and procedures:** Another critical challenge before the Self-Regulatory Organizations in a country like India is to continuously search for developing innovations in products/services, operations and procedures and thereby help to reach the neglected, underprivileged sections of the society. There is always greater scope for the **d**eveloping innovations in products/services, operations and procedures by observing the best practices adopted by various nations across the globe and by encouraging research in this field.
5. **Maintenance of transparency and accountability:** One of the major criticism against Self-Regulatory Organizations at large, is that their operations are not transparent and accountable, as the SRO would be accountable primarily to its members rather than to the public. Moreover, there is no statutory regulation till to

date with regard to disclosing their operations in the field. Hence, maintaining transparency and accountability up to the satisfaction of the stakeholders is one more challenge for the Self-Regulatory Organizations.

6. **Dealing with the technology:** Another notable challenge before the Self-Regulatory Organization in Microfinance Sector in India would be dealing with technology. Information and Communication technology has reached new horizons; the SROs need to utilize it not only for their own benefit but for the benefit of their members as well. Adopting the desired technology, creation of necessary infrastructure and utilizing the services of skilled manpower is going to be a challenge for SROs in India, due to constrained financial status of MFIs.

9. CONCLUSION

Development and Regulation of Micro Financial Institutions is a long overdue. Though it is late, everyone appreciate and welcome the move of the Central Government to introduce Micro Finance (Development and Regulation) Bill, 2012. All NBFC-MFIs must be members of at least one Self-Regulatory Organization (SRO) recognized by the RBI and comply with the Code of Conduct prescribed by the SRO is also another good move in the right direction.

SROs are primarily responsible for establishing the standards, under which their members conduct business, protect interests of the members and strengthen market integrity while maintaining efficient and competitive markets for microfinance. In the end, regulation alone cannot rebuild and maintain trust and confidence of the stakeholders. SROs must continue to focus their efforts on ensuring that industry leaders adopt the right 'tone at the top' and encourage a strong and ethical corporate culture. This is critical to rebuild trust and confidence in the financial services industry.

Being a regulatory authority, the Reserve Bank of India should evolve a strategy to strengthen the SROs in such a way that they should insulate themselves from all kinds of pressures either from its own members or from the outsiders. Then only, the Self-Regulatory Organizations can live up to the expectations of all.

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