Existing Legal and Regulatory Framework for the Microfinance Institutions in India: Challenges and Implications

Sa-Dhan
The Association of
Community Development
Finance Institutions

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Abbreviations

ADB	Asian Development Bank
APMACS Act	Andhra Pradesh Mutually Aided Cooperative Societies Act
ASA	Activists for Social Alternatives
BASIX	Bhartiya Samruddhi Finance Limited
BOU	Central Bank of Uganda
BPR	Local Level Micro Banks in Indonesia
CARE	Credit Analysis and Research Limited
CEO	Chief Executive Officer
CERUDEB	Centenary Rural Development Bank
CMC	Cashpor Micro-Credit Company Limited
CMFL	Commercial Microfinance Limited
CRISIL	Credit Rating Information Services India Limited
CRR	Cash Reserve Ratio
DIP	Disclosure and Investor Protection
DNBS	Department for Non-Banking Supervision
ECB	External Commercial Borrowing
EIR	Effective Interest rate
FCRA	Foreign Contribution Regulation Act
FDI	Foreign Direct Investment
FI	Financial Institutions
FPO	First Public Offer
IASC	Indian Association for Savings and Credit
ICRA	Investment Information and Credit Rating Agency
IDBI	Industrial Development Bank of India
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFCI	Institutional Finance Corporation of India
IPO	Initial Public Offer
IRDA	Insurance Regulatory and Developmental Authority
IRDP	Integrated Rural Development Programme
IT Act	Income Tax Act
LDKP	Local Non Bank Financial Institution
LIC	Life Insurance Corporation of India
MACS	Mutually Aided Cooperative Society

MACTS	Mutually Aided Cooperative Credit and Thrift Society
MBT	Mutually-aided Benefit Trust
M-CRIL	Micro-Credit Ratings International Limited
MDI	Microfinance Deposit taking Institution
MFI	Microfinance Institution
MIS	Management Information System
MSCA	Multi State Cooperative Act
NABARD	National Bank for Agricultural and Rural Development
NBFC	Non Banking Finance Company
NGO	Non-governmental Organisation
NOF	Net Owned Fund
NRB	Royal Bank of Nepal
OSS	Off Site Surveillance
PFF	Private Finance Fund
QIB	Qualified Institutional Buyer
RBI	Reserve Bank of India
RMK	Rashtriya Mahila Kosh
RRB	Regional Rural Bank
SEBI	Securities Exchange Board of India
SEWA	Self Employed Women's Association
SHG	Self Help Group
SIDBI	Small Industries Development Bank of India
SKS	Swayam Krishi Sangam
SLR	Statutory Liquidity Ratio
SRFS	Sanghamitra Rural Financial Services
UCB	Urban Cooperative Bank

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Preface

The imagination, with which microfinance was put into practice, has been turning into a reality in India. The unparalleled growth of microfinance institutions, to cover a vast majority of unbanked population in need of financial services, is just a step towards achieving the goals of development for building an equitable society. Microfinance initiatives have been accepted at different levels viz. the policy makers, the regulators and the implementers, as an effective way to address the financial needs of the poor.

The crucial role of microfinance in alleviating poverty and need for an enabling regulation for microfinance sector has been acknowledged by various high-level government committees. To name a few — the Vyas Committee on 'Flow of Credit to Agriculture and Related Activities from the Banking System and the Internal Group', headed by Dr. H R Khan, on rural credit and microfinance. The announcements in the Union Budget 2005 by the Hon'ble Finance Minister, P. Chidambaram, provided impetus to the microfinance sector and following this, the sector observed crucial initiatives to promote a conducive policy and operational environment for the microfinance sector in India. The Annual Credit Policy-2006 has also addressed the need for including the "financially excluded" population within mainstream banking facilities.

Since its inception Sa-Dhan, being a network of community development financial institutions in India, has been endeavouring to develop better understanding among a diverse set of stakeholders on different legal and regulatory frameworks for the microfinance sector. During its six years of operation in the Indian microfinance sector, Sa-Dhan has learnt that a better understanding of these frameworks would lead to informed choices and building a consensus among all the partners in this change process.

With a detailed study on the legal, statutory and financial requirements of each institutional design under which microfinance institutions operate generally, Sa-Dhan intends to disseminate information on a wide spectrum including both the external as well as internal stakeholders of the microfinance sector. The present study, *Existing*

Legal and Regulatory Framework for the Microfinance Institutions in India: Challenges and Implications, objectively examine the existing legal framework under which the entire microfinance sector operates at present. It covers the whole gamut of laws, regulations and various requirements by the microfinance institutions for their operations.

The study covers the legal and regulatory aspects of microfinance institutions in detail. Chapter one explains the structural evolution of microfinance institutions in India. It outlines their evolutionary and legal context in India. It details the types of legal forms available to them with suitable examples. The second chapter deals with the existing legal framework for various institutional forms and reviews the legal text relating to each of the legal forms being used by microfinance institutions in India. It also outlines the regulatory framework for those forms and identifies the pros and cons of each form. The next chapter discusses the statutory requirements for different types of legal entities engaged in microfinance service delivery. It details the prudential norms, capitalisation issues and disclosure requirements that must be satisfied by each type of entity.

The techno-managerial capacity requirements with respect to the legal framework are discussed in the fourth chapter. It details the management capabilities of Indian microfinance institutions and relates these to the needs imposed by the regulatory environment on different legal forms. It also covers trends in the management practices of microfinance institutions and the resulting implications for transformation into a different legal form. To highlight the importance of facilitating legal environment, an international perspective has been included in the study as the fifth chapter. It provides a comprehensive discussion on the international experience of the effect of regulatory framework on the choice of legal form by microfinance institutions.

Sa-Dhan believes that this study will be a useful supplement to get inclusive and comprehensive information about the existing legal environment and its implications thereupon. At this juncture, Sa-Dhan would like to thank all the stakeholders associated, directly or indirectly, in the completion of this study. Sa-Dhan hopes that this initiative will usher in positive social changes. All comments and suggestions, if any, are welcome.

Mathew Titus
Executive Director
Sa-Dhan
December, 2005

Acknowledgements

Since its inception, Sa-Dhan has been continuously engaged with the policy makers, regulators, practitioners and other major stakeholders in creating a facilitating and enabling legal and regulatory environment for the microfinance sector in India. The present study, "Existing Legal and Regulatory Framework for the Microfinance Institutions in India: Challenges and Implications" is a part of this ongoing process to understand the contextual issues arising out of the present regulatory regime governing the microfinance sector both at the micro and macro level. This study analyses the existing laws and regulations, which govern the entities that are currently delivering the microfinance services.

We express our sincere gratitude to Mr Sanjay Sinha, Managing Director, Micro Credit Ratings International Limited (M-Cril), Gurgaon for his invaluable contribution in bringing out this study. We are also highly grateful to Mr Nilotpal Pathak, Senior Executive, M-Cril for his commendable efforts in carrying out the study and being part of the deliberations and discussions to incorporate the suggestions on several occasions during the whole process. We also gratefully acknowledge the assistance of Mr M Sreenivasan, Company Secretary, for vetting the final report and providing his valuable inputs on the authenticity of the legal references provided in the report on behalf of M-Cril.

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Finally, we would like to acknowledge the necessary support and help provided by Small Industrial Development Bank of India (SIDBI) in carrying out this study.

We sincerely hope that this study will not only result in enhancing the knowledge base of practitioners, but will also broaden the focus on the best practices being carried out by some of the leading microfinance institutions in the country. We welcome all comments and suggestions on the report by our readers.

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December 2005

1 STRUCTURAL EVOLUTION OF MICROFINANCE INSTITUTIONS IN INDIA

This section outlines the evolutionary and legal context of microfinance institutions in India. It details the types of legal forms available to microfinance institutions and provides some examples.

The exchange of money in the form of credit as well as cash between various participants in the economy is a practice that has been traced back some 5,000 years to the ancient civilizations of Greece and Mesopotamia. Ancient India was one of the early adopters of the monetary exchange system with evidence of its use over 3,000 years ago and the dating of the earliest Indian coins to shortly after the death of the Lord Buddha around 400 BC. India and South Asia developed their own monetary tradition, albeit subject to the influences of Iran and the Graeco-Roman world. The first references to credit occur in Vedic texts and followers of the Lord Mahavira, the Jains, initially took on the role of India's bankers.[1]

1.1 FINANCIAL SERVICES FOR THE POOR DO EXIST…[2]

While informal financial services have always been an integral part of the traditional economy-my of India,[3] even semi-formal and formal financial services through agricultural cooperatives and banks are within physical reach (less than 5 km) of perhaps 99 per cent of the population of the country. A vast network of commercial banks, cooperative banks and regional rural banks (RRBs) as well as other financial institutions (FIs) provide such services. Other FIs include non-bank finance companies (NBFCs), insurance companies, provident funds and mutual funds. There are more than 1,58,000 retail credit outlets in the cooperative and banking sectors, augmented by another 13,700 or so NBFCs (of which, however, under 600 have been licensed to accept deposits). Of these, there are some 94,000 cooperative societies or branches of cooperative banks, around 60,000 branches of 27 public sector commercial banks and 196 RRBs and another 4,700 branches of 55 smaller private banks, all providing financial services in India. There is also a growing number of foreign banks operating but their reach, through some 200 branches, is limited to the main cities.[4]

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[1] Williams, J. ed., 1997. Money: A History. New York: St Martin's Press. Modern Iraq broadly covers the area that was known as Mesopotamia in ancient times.

[2] Much of the discussion in the first three sections is based on Sinha, 2000. *India Country Study* in Asian Development Bank, 2000. *The Role of Central Banks in Microfinance in Asia and the Pacific.* ADB: Manila.

[3] See Ghate, P., 1992. *Informal Finance*. Oxford: Oxford University Press as well as Rutherford, S and Arora, SS, *City Savers*, New Delhi: DFID, 1997 amongst other sources of information on ROSCAs, Chit Funds and other informal means of obtaining finance.

[4] Reserve Bank of India, *Report on Currency and Finance*, 1997-98.

Formal financial services are, in theory, available to low income families mainly through 33,000 or so rural and 14,000 sub-urban branches of the major banks and RRBs and by 94,000 cooperative outlets – either bank branches or village level primary societies. Financial services to the poor are also available from - agents of NBFCs. The RRBs, in particular, were established specifically in order to meet the credit requirements of the poor – small and marginal farmers, landless workers, artisans and small entrepreneurs and should, therefore, have emerged as a major source of microfinance. A total of 140,000 institutional outlets serving the rural sector and the poor implies the availability of one outlet for every 5,600 persons – in theory, a very favourable ratio for catering to the financial needs of-low income families.

1.2 BUT THEIR AVAILABILITY IS A MIRAGE

For many years, bankers and senior government officers were fond of describing the Government of India's (GoI) main poverty alleviation programme, the Integrated Rural Development Programme (IRDP), as "the world's largest microfinance programme". And so it was. It involved the commercial banks in giving loans of less than Rs 15,000 to poor people and, in nearly 20 years, resulted in financial assistance of around Rs 250 billion to roughly 55 million families.[5] The problem with IRDP was that its design incorporated a substantial element of subsidy (25-50 per cent of each family's project cost) and this resulted in extensive malpractices and mis-utilisation of funds. This situation led bankers too to see the IRDP loan as a politically motivated hand-out and they largely failed to follow up with borrowers. The net result was that estimates of the repayment rates in IRDP ranged from 25-33 per cent. Not surprisingly, the two decades of IRDP experience – in the 1980s and 1990s – affected the credibility of micro-borrowers in the view of bankers and, ultimately, hindered access of the usually less-literate poor to banking services.

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

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[5] This suggests that virtually all the 60 million or so poor families were covered by the IRDP. Alas, this was not the case as the numbers include many cases of repeat assistance (deliberate) and perhaps even more cases of unjustified selection of 'beneficiaries'.

[6] For a more detailed discussion, see Sinha, 2000, *op cit.*

1.3 SO THE SEMI-FORMAL NGO-MFI SECTOR HAS STEPPED IN

Over the past 20-25 years, the resultant vacuum in the financial system has started to be filled, initially with the pioneering efforts of development organisations such as the SEWA Bank (Ahmedabad), Annapurna Mahila Mandal (Mumbai) and Working Women's Forum (Chennai) but, more vigorously during the 1990s, by the entry of significant numbers of non-government organisations (NGOs) into microfinance. Current estimates of the number of NGOs engaged in providing microfinance services to the poor exceed 1,000 organisations (M-Cril's estimate based on the experience through research in the field of rural finance and ratings of microfinance institutions in different parts of India).[7]

Initially, many NGO microfinance institutions (MFIs) were funded by donor support in the form of revolving funds and operating grants. In recent years,[8] development finance institutions such as NABARD, SIDBI and microfinance promotion organisations such as the Rashtriya Mahila Kosh (RMK - the National Women's Fund) have provided bulk loans to MFIs. This has resulted in the MFIs becoming intermediaries between the largely public sector development FIs and retail borrowers consisting of groups of poor people or individual borrowers living in rural areas or urban slums. In another model, NABARD refinances commercial bank loans to self-help groups (SHGs) in order to facilitate relationships between the banks and poor borrowers. This movement has witnessed significant progress over the last 10 years and has brought changes in the rural banking system.

Though, in most cases, the organisations earlier involved in developmental works have made a start in providing "user friendly" formal financial services to the poor, gradually transforming themselves into MFIs, their outreach is still minuscule in comparison with the need. Recent compilations of support provided by major FIs shows that the microfinance outstandings of domestic FIs (including non regulated NGO-MFIs) did not exceed Rs 3,500 crore (US$804 million) by March 2005 with an outreach of less than 15 million families – at best less than 25 per cent of the 60-70 million poor families in the country. This includes the NABARD scheme for linking SHGs directly with banks. The available data indicates that progress and outreach in the latter scheme was around Rs 2,000 crore (US$460 million) outstanding and covering, at most, 10 million families as per March 2005 estimates.[9]

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[7] This number includes all registered societies, trusts, a few NBFCs and "new generation" cooperatives acting as financial intermediaries. It specifically excludes unregistered self-help groups that are usually established and facilitated by the NGOs; and it also excludes conventional cooperatives.

[8] Roughly since 1994

[9] M-Cril' estimate for the number of families. The information available on this programme does not cover amounts outstanding or the number of SHGs with outstanding loans. The numbers on the NABARD linkage have been estimated on the basis of data available at the NABARD website.

At the same time, the involvement of commercial banks in microfinance is negligible both in relation to the current volume of microfinance and (even more so) to their broader engagement in rural areas. The total credit from the scheduled commercial banks to the "weaker sections"[10] is estimated at Rs 32,300 crore (US$ 7.5 billion) at the end of March 2004 compared to the total rural deposits of Rs 176,000 crore (US$ 41 billion).[11]

1.4 AND DELIVERS MICROFINANCE THROUGH A VARIETY OF LEGAL FORMS

Since microfinance was taken up mainly as a development initiative rather than as a commercial activity, the voluntary development agencies (or NGOs) who were registered either as societies, trusts or Section 25 companies, did not think of looking at alternative institutional forms for providing these services – though some cooperatives and one cooperative bank were also engaged specifically in microfinance. As the scale of operations of microfinance activities started growing and, along with that, the desirability of undertaking such activity on a for-profit basis started coming into focus, the larger institutions started to feel the need for a transformation in their legal structure. As a result, MFIs in India can now be found in the form of NBFCs as well.

Of the 1,000+ MFIs in the country today, perhaps 400-500 continue to operate in the form of registered societies or trusts[12]. While institutions like ASA Trust, Tamil Nadu and Nav Bharat Jagriti Kendra, Jharkhand were established initially for a wide range of development activities, some key institutions in the country today were established specifically for microfinance but registered as societies for lack of an appropriate alternative. Examples of these are Swayam Krishi Sangam (SKS), based at Hyderabad and operating in the Telangana region of Andhra Pradesh, and Grameen Koota based in Bangalore and operating in the rural areas near the city. ASA is registered as a trust under the Indian Trust Act as are other institutions such as Mahasemam and ASSEFA (also in Tamil Nadu).

Another 300-400 MFIs in India operate as cooperatives either under the conventional state-level cooperative acts, the national level multi-state cooperative legislation or under the new state-level mutually aided cooperative acts (MACS Act).[13] Notable examples of cooperatives operating under the conventional acts are the Annapurna Mahila Cooperative

[10] "Weaker sections", official parlance for the poor and under-privileged sections of society. Includes all families officially classified as poor but also some non-poor who belong to the lower castes or to specified groups of other religious minorities.

[11] Bankers' attitudes which limit commercial bank exposure to microfinance are extensively discussed in Goodwin-Groen, Ruth, *The Role of Commercial Banks in Microfinance: Asia Pacific Region*. Brisbane, Australia: Foundation for Development Cooperation, 1998.

[12] M-Cril's estimate for the number of MFIs.

[13] As discussed above, the actual number of primary thrift and credit cooperative societies in India is very high, close to one lakh, but a large proportion of these are defunct and are mostly very small. The number of 300-400 here only estimates the number of cooperative institutions that are likely to have more than 100 members.

Credit Society in Mumbai, the Indian Cooperative Network for Women (of the Working Women's Forum) in Chennai, Ankuram Sangamam Poram in Hyderabad and Pushtikar Laghu Vyaparik Pratishthan in Jodhpur. Some of the district cooperative banks – such as DCCB Bidar (in northern Karnataka) – have also started to take a significant interest in microfinance. Of the state-level MACS Acts there has been a significant impact so far only in Andhra Pradesh – which pioneered this regulatory form. There are now many significant Mutually Aided Cooperative Thrift Societies (MACTS) in Andhra Pradesh which, therefore, account for the bulk of the 300-400 number cited above. Some better performing examples of such MACTS are the ACTS Mahila MACTS based in Chittoor, the PWMACTS in Vishakhapatnam and the Indur MACTS Federation in Nizamabad.

More recently, a trend to register MFIs as companies has emerged. Some are registered as not-for-profit companies under Section 25 of the Companies Act, at least partially to take advantage of the Reserve Bank of India's (RBI) exemption from registration for such companies providing microfinance services. Notable examples of these include the Cashpor Microcredit Company Ltd (CMC), based at Varanasi and operating in the eastern part of Uttar Pradesh and western Bihar, and Sanghamithra Rural Financial Services Limited (SRFS) based at Bangalore, operating in Karnataka. However, these are still relatively few in number, perhaps no more than ten.

Another, form of registration that indicates a bolder, overtly commercial (and in the long term, institutionally more sustainable) approach to microfinance is the establishment of a for-profit company followed by registration with the RBI as an NBFC. A number of MFIs are considering this route and a few have either already transformed into NBFCs or are in the process of doing so. Some of the largest MFIs in the country now operate as for-profit NBFCs. Key MFIs that have already converted their MFI form into for-profit NBFCs (or started as such) are Bhartiya Samruddhi Finance (of BASIX), Hyderabad (operating in the states of Andhra Pradesh, Karnataka, Orissa and Maharashtra), SHARE Microfin, based at Hyderabad and operating in the states of Andhra Pradesh, Orissa and Chattisgarh, Spandana, based at Guntur and operating largely in the urban areas of coastal Andhra Pradesh and Sarvodaya Nano Finance (of ASSEFA), based at Chennai and operating in much of Tamil Nadu.

Though a look at the operational profile of each of the NBFCs suggests that transformation of large MFIs into this form has helped them to scale up operations significantly, the form still has significant constraints, particularly in the regulatory limitations on the range of financial services they are able to offer. These limitations are discussed later in this report.

The following section discusses the legislation on which each of the organisational forms discussed above is based before the report reviews the status of the present regulatory frameworks and prudential norms that must be adhered to by MFIs operating in India.

2 Review of Legal Text and Framework for Various Institutional Forms

This section reviews the legal text relating to each of the legal forms being used by microfinance institutions in India, outlines the regulatory framework for those forms and identifies the pros and cons of each form.

2.1 SOCIETIES REGISTRATION ACT, 1860

As discussed in Section 1, NGOs are mostly registered under the Societies Registration Act, 1860. Since these entities were established as voluntary, not-for-profit development organisations, their microfinance activities were also established under the same legal umbrella. This sub-section examines the provisions of the Societies Act from the perspective of the practice of microfinance in India.

2.1.1 Purpose

The Societies Registration Act 1860 states that "a society can be formed for the promotion of literature, science or the fine arts or the diffusion of useful knowledge/political education or for charitable purposes." Various state governments have amended these purposes from time to time. However, *charitable activities* continue to form the core of the stated purpose of the act in each of these cases.

Over a century-and-a-half since the enactment of this law, the Act has been subject to too much legal interpretation. In 1891, a high court judge, Lord McNaughten, defined, the legal sense of the term charity to comprise trust for

(i) relief of poverty
(ii) advancement of education
(iii) advancement of religion
(iv) purposes beneficial to the community or a section of the community.

Lord Camden, in the same judgement in 1891,[14] defined charitable purposes as "a gift to general public houses which extends to poor as well as rich, equally. It may be laid down as universal rule that the law recognises no purpose as charitable unless it is of a public character, that is to say a purpose must, in order to be charitable, be directed to the benefit of the community or a section of the community."

[14] SCIT vs Pemsel (1891) 3 TC 53 96 cited in Nabhi, 2004. Formation & Management of a Society. 16th edition.

Considering the public nature of microfinance activities and the widely accepted notion of its being help for the relief of poverty and for benefit to the community, microfinance activities are interpreted by most of civil society as being charitable for the purpose of this act. Under this law, as a pre-requisite, the registered society would, however, need to mention microfinance clearly as an activity it would be taking up as part of its "charity" work – as one of the objectives in its Memorandum of Association.

2.1.2 Registration of Society

Once the name of the proposed society and also the draft memorandum and rules and regulations of the society have been decided, the procedure for the registration of the society can be taken up. All the subscribers (minimum seven) should sign each page of the memorandum and the signatures should be witnessed by an oath commissioner, notary public (Rs 3 notarial stamp duly affixed), gazetted officer, advocate, chartered accountant or magistrate 1st class with their rubber/official stamp and complete address. The persons desirous of forming a society should also become members of the first governing body. An outsider cannot become a member of the governing body in the first instance.

The following papers should be filed with the Registrar of Societies for registration under the Principal Act or corresponding Acts enacted by various state governments:

a. covering letter requesting for registration stating in the body of letter various documents annexed to it. It should be signed by all the subscribers to the memorandum or by a person authorised by all of them to sign on their behalf.
b. Memorandum of Association in duplicate alongwith a certified copy. It should be neatly typed and pages serially numbered.
c. Rules and regulations/bye-laws in duplicate duly signed.
d. Where there is a reference to any particular existing places of worship like Temple, Gurdwara, Church, Masjid or Budhvihar, etc. sufficient documentary proof establishing legal competence and control of applicant society over such places should be filed.
e. Affidavit on non-judicial stamp paper of appropriate value sworn by the president or secretary of the society stating the relationship between the subscribers. The affidavit should be attested by an oath commissioner, notary public or magistrate 1st class.
f. Documentary proof such as house tax receipt, rent receipt in respect of premises shown as registered office of the society or no-objection certificate from the owner of the premises.

Normally a fee of Rs 50 is payable as registration fee of a society and it should accompany the request for registration payable in cash or by demand draft. Formalities for registration and requirement of documents may differ slightly from state to state. The applicant may, therefore, contact in advance the Registrar of Societies having jurisdiction.

On receiving the documents mentioned above the Registrar shall satisfy himself about the compliance of the provisions of the Act and correctness of the documents and then certify in his hand that the society is registered under the Principal Act 1860 or other corresponding Acts. Presumption that the society was duly registered under the Act arises not on the Certificate of Registration granted by the Registrar but on the copies of the Rules and Regulations and Memorandum certified under Section 19 which constitutes them prima facie evidence of the matters therein contained.

2.1.3 Duties and Responsibilities of the Governing Body

Members of the governing body of a society are the trustees of the property of the organisation. Therefore, the management of the assets and liabilities of the organisation is the responsibility of the governing body members. Many provisions in the Principal Act provide the manner in which the society is required to function and for all purposes it is the governing body that is responsible for the conduct of the society.

2.1.3(a) Investment of Funds of a Society by the Governing Body

Given the financial nature of work of MFIs, such institutions are involved in the transaction of funds of high volume. It is the prime duty and responsibility of the governing body to invest and apply the funds and property of the Society. The governing body also needs to take care that the funds are not misappropriated or misused. No specific provision or guidelines are available in the Principal Act regarding the application of the funds of the Society but it is established law that the governing body of the Society are trustees of the funds of the Society and thus they should apply the funds in the most judicious manner as well as in a manner a prudent man would apply his own funds.

2.1.4 Accounts & Audit

The Principal Societies Act does not provide for the maintenance of accounts or their audit in any manner. State governments have made amendments to the Act, which are applicable to the societies registered in that particular state. Provisions for accounts and audit have also been made in various independent laws enacted by various states. These include provisions for every society to

- Keep at its registered office proper books of accounts containing entries in respect of all sums of money received and the sources thereof and all sums of money spent by the Society and the objects or purposes for which the sum is spent.

- Maintain the records of all sales and purchases of goods by the Society and also the records of assets and liabilities giving a true and fair view of the state of affairs of the society.
- For this purpose, societies should maintain a cashbook showing daily receipts and expenditure and balance at the end of the day, receipt books containing forms in duplicate, one of each set, to be issued with details of money received by the Society and the other to serve as counterfoil, voucher files containing all vouchers for contingent and other expenditure incurred by the society, numbered serially and filed chronologically.

To keep an independent check on the accounts maintained by the societies, various provisions have been made by state governments for auditing of their accounts. The auditing of accounts by independent persons with specified qualifications has been specified in these provisions and the auditors are required to prepare and sign a report of their observations after auditing the account books. Every society needs to have its accounts audited once a year by duly qualified auditors and obtain a balance sheet prepared by that auditor. A duly qualified auditor means a chartered accountant within the meaning of the Chartered Accountants Act, 1949 or a person approved by the Registrar of Societies in this behalf. The auditor should submit a report showing the exact state of financial affairs of the society. If the society fails to get its accounts audited, the Registrar of Societies may cause the accounts of the society to be audited and recover the cost from the society. If the society neglects or refuses to furnish records available for audit, the Registrar may order investigation into the affairs of the society.

2.1.5 Powers and Duties of the Registrar of Societies

The Registrar of Societies in each state enforces the provisions of the Principal Act or the corresponding Acts enacted by the other states. The Principal Act does not define the term ‘Registrar’. It also does not express the powers which the Registrar may exercise, except for indirect reference to the powers of the Registrar under Sections 1,2,3,4,17, 18 and 19. The powers and duties of the Registrar are to

a. certify and inspect documents;
b. call for documents;
c. enquire into and settle disputes;
d. investigate the affairs of a Society (in case the Registrar himself, or upon the instruction of the state governments, is satisfied that the circumstances suggest that the business of the Society is being conducted with intent to defraud its creditors, members or any other person or there is apprehension that the affairs of the Society are being so conducted as to defeat the objects of the society or that the society is guilty of mismanaging its affairs or engaging in any fraudulent or unlawful act.)

e. cancel registration;
f. refuse registration;
g. amend memorandum of association;
h. seize records;
i. enforce attendance of governing body members;
j. order audit;
k. compound offences;
l. settle disputes regarding the election of office bearers;
m. restore property;
n. condone delays; and
o. appoint liquidators.

It is clear from this list of powers that the Registrar does not have overbearing powers in terms of handling of the affairs of a Society. With respect to the functioning of the microfinance operations of a society, the Registrar has no responsibility for any form prudential regulation or determination of its financial performance or solvency. The Registrar can intervene only if a major dispute arises in the management of the Society or there is apprehension of an intention to defraud the creditors of the society or to engage in other unlawful or unauthorised acts.

2.1.6 Taxation

Section 11 of the Income Tax Act, exempts the income of charitable societies from the charge of tax on the fulfillment of certain conditions. Apart from this, sections 12, 12A, 12AA and 13 and certain clauses of Section 10 of Income Tax Act also govern the issue of taxation of such organisations. Since the object of microfinance may be considered a charitable function, local assessing officers of the Income Tax Department often exempt the income from microfinance activities from income tax. However MFIs need to apply to the income tax authorities to get this exemption. The wealth of the societies however, is subjected to wealth tax at 1 per cent of the net value of the wealth with a basic exemption of Rs15 lakh.

For availing exemption under Section 11, the society is required to fulfill the following conditions:

a. Registration: For registration under Section 12AA with the Commissioner of Income Tax, the Society or Trust or institutions should apply within one year from the date of creation of Society or establishment of institution, in Form No 10A (in duplicate) along with the memorandum of association or bye-laws of the society in original or the document evidencing creation of the Trust, together with a copy thereof and two copies of the accounts of the society relating to three previous years (or for the year during which the Society or Trust was in existence, in case of a new Society). The Commissioner shall call for documents or information and hold enquiries regarding the genuineness of the Society/ institution. After being satisfied about the charitable or religious nature of its objects and genuineness of its activities, he will pass an order granting registration, and if he is not satisfied, he will pass an order refusing registration, subject to the condition that an opportunity of being heard shall be provided to the applicant before an order of refusal to grant registration is passed and the reasons for refusal of registration shall be mentioned in such order. The order granting or refusing registration has to be passed within six months from the end of the month in which the application for registration is received and a copy of such order shall be sent to the applicant society/institution. If the Commissioner of Income Tax is satisfied that the activities of any institution are not genuine or are not being carried out in accordance with the objects of the institutions, he shall, after giving reasonable opportunity of being heard to the concerned institution, pass an order in writing cancelling the registration granted under Section 12AA.

b. Maintenance of Accounts: The Society should maintain regular books of account, supported by receipts and vouchers. The accounts shall be made on a cash basis. The Society should prepare an 'Income and Expense Account'. Any voluntary contribution received by the society shall be deemed to be income derived from the property held under trust. Where contribution have been made with a specific direction that they shall form part of the corpus it should be so specified on the receipt issued as the same shall be exempt under section 11 (1)(d).

c. Compulsory Audit: Where the total income of the society /institution exceeds Rs 50,000 in any previous year, the accounts of such society are required to be audited and the audit report which shall be in Form No 10B is required to be furnished along with the return.

d. Income not to be spent for the benefit of certain persons: No part of the income or property of a charitable society claiming exemption under Section 11 should be used or applied for benefit of any person specified under Section 13/3, subject to certain exceptions.

In the event of refusal to tax exemption, societies need to pay tax on their income, as per the terms laid down in the Income Tax act. Societies involved in for-profit activities also pay tax as per the terms in the Income Tax act. These tax paying societies can also make investments in the for-profit ventures or bodies, based on their risk appetite.

2.1.7 Acceptance of Foreign Contributions

Acceptance of foreign contribution by MFIs registered under the Societies Registration Act 1860 is regulated by the Foreign Contribution (Regulation) Act 1976 (FCRA). This Act defines foreign contribution as donations or delivery of transfer made by any foreign source

a. of any article, not being an article given to any person as a gift for his personal use, if the market value in India of such article, on the date of such gift, does not exceed one thousand rupees;
b. of any currency, whether Indian or foreign; and
c. of any foreign security.

Besides, 'foreign contribution' includes contribution (referred to above) received from one or more organisations within India whose original source is foreign.

In order to access foreign contributions, MFIs need to make applications in form FC-8 of FCRA to the Secretary, Ministry of Home Affairs, New Delhi. Once registered with the Ministry of Home Affairs, these organisations have to agree to receive such foreign contribution only through one of the branches of a bank as it may specify in its application for registration. All such registered organisations need to submit, within a period of four months from the closure of financial year, intimation in Form FC 3 (as per the format prescribed in the FCRA), in duplicate, to the central government as to the following

a. amount of each foreign contribution received by it;
b. the source from which the contribution was received; and
c. the manner in which it was utilised.

Provided that where such association obtains any foreign contribution through any branch other than the branch of the bank through which it has agreed to receive foreign contribution or fails to give such intimation within the prescribed time or in the prescribed manner, or gives any intimation which is false, the central government may, by notification in the official gazette, direct that such association shall not, after the date of issue of such notification, accept any foreign contribution without the prior permission of the government.

All associations receiving foreign contribution are required to maintain separate accounts for such foreign contributions. The accounts must be maintained on a financial year basis from the first day of April each year and every such yearly account must be furnished in duplicate, duly certified by a chartered accountant to Secretary, Government of India, Ministry of Home Affairs. All these organisations must also get their accounts audited by a chartered accountant. The auditor must certify and issue the following reports:

a. Intimation of foreign contribution in form no FC-3;
b. Balance Sheet as on March 31 of that year; and
c. Statement of receipts and payments account for the year ending March 31.

The auditor has also to review the records including Form No FC-6 (the articles of accounts) as well as Form No FC-7 (the securities account) as well as certify the receipt and utilisation of foreign contributions in kind such as vehicles, medicines, equipment and so on.

2.1.8 Dissolution

Dissolution of an MFI registered under the Societies Registration Act 1856, leads to the cessation of the society's activities. From dissolution arises a need to settle the liabilities of the dissolved societies as also to suitably dispose of its surplus assets. Upon dissolution, steps should be taken by the society for the disposal of the property of the society and settlement of its claims and liabilities in terms of the existing rules of the society. If rules do not indicate the manner of disposal of its properties, the Registrar may decide about the disposal of properties in suitable manner itself with appropriate majority vote or in a manner directed by the general body or a court of law.

The Principal Act provides that if any property remains surplus after the satisfaction of all the debts and liabilities of the society, it cannot be paid to or distributed among the members of the Society or any of them. The members by three-fifth majority may decide to give the surplus properties to some other Society. In the event of any dispute among the members regarding the disposal of surplus property the matter may be referred to the Principal Court of civil jurisdiction for disposal. These provisions are mandatory and if after adjustment of claims and liabilities some property is left, it must go to some other Society with kindred object even if the rules of the society contain a provision for the division of the property of the society upon dissolution among its members.

Most of the state Acts have similar provisions for the dissolution of societies. However they differ on the degree of majority votes of the general body of the society. While states like Bihar, Gujarat, Jammu & Kashmir and Maharashtra allow a simple majority vote to take a decision on the modality of disposal of surplus assets, other states like Karnataka, Kerala, West Bengal, Madhya Pradesh, Andhra Pradesh and Pondicherry require a three-fifth majority (with Rajasthan requiring a two-third majority).

2.1.9 Compatibility with Insurance Regulations

As per the regulation of the Insurance Regulatory and Development Authority (IRDA), societies are not allowed to take up any type of insurance business on their own. However, they are allowed to function as an agency (but not as a corporate agency[15]) for an insurance company registered with IRDA. Any Society can have an agency for one life insurance and/or one non-life insurance company. The Society needs to fulfill the conditions laid down by IRDA. The proposed regulation on micro-insurance also recognises NGOs registered as societies as an important vehicle to deliver micro-insurance to a wide cross-section of poor clients.

2.1.10 Advantages and Disadvantages for MFIs of Registration under the Societies Act

Advantages

- i simple process of registration;
- ii simple record keeping and even simpler regulations;
- iii low possibility of interference by the regulator;
- iv (largely) exemption from tax due to the overtly charitable nature of operations; and
- v appropriate for taking up micro-insurance (as an agency) on behalf of insurance companies.

Disadvantages

- i as a charitable institutional form, in essence inappropriate to the for-profit, financially sustainable strategic goal of microfinance operations;
- ii tax-exemption for surpluses can be (and is) challenged on the question of whether provision of microfinance services is a charitable activity;
- iii no system of equity investment or ownership, thereby, making it less attractive for commercial investors interested in microfinance;
- iv commercial investors generally regard the investments in such entities risky primarily on account of their lack of professionalism and managerial practices and are, therefore, reluctant to commit large volumes of funds to such MFIs;
- v In accordance with Section 45S[16] of the RBI Act, 1934, no unincorporated bodies are allowed to accept deposits from the public. Organisations registered under the Societies Registration Act and the Trust Act are considered unincorporated bodies[17]. Therefore, according to the law, they are not even allowed to collect savings from their clients; and

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[15] As per the guidelines of the Insurance Regulatory and Development Authority (IRDA), a Corporate Agency would be a company registered under the Companies Act, whose primary business would be other than distribution of insurance products, and insurance product distribution should be a subsidiary business. In exceptional cases, the license for corporate agency is granted exclusively for the insurance distribution. However in such cases also the agent should be a public limited company with a minimum share capital of Rs15 lakh and to be managed by insurance professionals.

[16] Section 45 of RBI Act provides regulatory guidelines on the issues related to deposit mobilisation by non-banking institutions and financial institutions.

[17] Unincorporated bodies are those who are not registered under the Companies Registration Act 1956.

vi also vulnerable to the use of 'usurious interest prevention acts' of various state governments as the status of microfinance is debatable as a charitable activity. A discussion on the Moneylenders (Prevention of usurious interest rates) Act is annexed with the report in Annex I.

2.2 INDIAN TRUSTS ACT, 1882

Some MFIs are registered under the Indian Trust Act, 1882 either as public charitable trusts or as private, determinable trusts with specified beneficiaries/members.

2.2.1 Formation of a Trust

As per Section 6 of the Indian Trust Act 1882, the essential constituents of a trust are

a. three parties – the author, trustees and beneficiary;
b. declaration of a trust;
c. certainty of the subject matter of a trust; and
d. certainty of objects of the trust.

According to Section 3 of the Act, the person who reposes or declares confidence in another person, in some property for the benefits of the beneficiary, is called the 'author' or 'settlor' of the Trust. The author is the creator of the Trust; he gives birth to the Trust. Under the Section 7 of the Indian Trust Act 1882, a Trust may be created by any person/ institution competent to contract. In the context of MFIs, the author of the Trust is an individual with the noble intention of providing financial services to the poor. He arranges for funds from various sources and then deploys the funds to the Trust for the sake of the beneficiaries.

The same section of the Act defines a trustee as a person who, while holding legal ownership and/or possession of, or dominion over, the subject matter of the trust, is bound to allow the beneficial enjoyment of the property to be reaped by another, called the beneficiary. In common parlance however, the word "trustee" is used in a very wide sense so as to include any person who stands in a fiduciary relationship with another, such as the manager, though strictly speaking they are not the trustees. A trustee is liable to indemnify the loss caused to the Trust property or sustained by the beneficiary due to breach of trust committed by him, except where the beneficiary has by fraud induced the trustee to commit the breach or where the beneficiary is an adult and of sound mind and has concurred in the breach or has agreed therein with full knowledge of all the facts. In the context of an MFI, the typical trustees consist of the board or the governing body of the institution that takes policy decisions on behalf of the board and, thereby, holds responsibility for the functioning of the trust.

Also there should be a third person for whose benefit the confidence is reposed by the author or accepted by the trustee. The author of the trust may himself be the beneficiary or one of the several beneficiaries under the Trust. As per Section 9 of the Indian Trust Act, every person capable of holding property may be a beneficiary under the Trust. The capacity to hold property is the only requisite qualification.

Text Box 1

A note on private and public Trusts

A Trust is said to be public when it is constituted wholly or mainly for the benefit of the public at large. The public trusts are essentially charitable or religious trusts. They are of permanent and indefinite character. On the other hand, in a private Trust the beneficial interest is vested absolutely in one or more individuals who are, or within a given time may be, definitely ascertained. In the words of the Supreme Court, the distinction between a private and a public Trust is that whereas in the former the beneficiaries are specific individuals, in the latter they are general public or a class thereof. While in the former the beneficiaries are persons who are ascertained or are capable of being ascertained, in the latter they constitute a body which is incapable of being ascertainment. While the private trusts are governed by the Indian Trust Act, 1882, public trusts are governed by the general law.

A clear declaration of the intention to create a Trust is necessary to form a valid Trust. The evidence of a declaration must be clear and distinct; the acts and writings of the settlor would be sufficient evidence of the declaration of a Trust. In the context of an MFI, the Trust may be declared by a non-testamentary instrument called a Trust deed. There is no prescribed form for a Trust deed. Any words, which indicate the intention of the author to form the Trust, would be sufficient. A Trust declared by a non-testamentary instrument comes into effect from the date specified in the instrument. Once this Trust deed is registered it becomes a valid official document. The following types of registration are associated with a private Trust:

a. Registration under the Indian Trusts Act (for the Trust deed only);
b. Registration under the Societies Registration Act (when the Trust is constituted as a Society), as discussed in the Section 2.1.2.
c. Registration under the Income Tax Act (though private Trusts are generally not required to register under the Income Tax Act as they are not exempted from Income Tax under Section 11, they may seek exemption for that part of their work which is charitable after obtaining registration under the Income Tax Act). Also the Mutually-aided Benefit Trusts (MBTs), a form of private trusts does not need to be registered under this act.

d. Registration under the Foreign Contribution (Regulation) Act, 1976 (for becoming eligible to received foreign grants for carrying out their activities); as discussed under the Section 2.1.7.

2.2.2 Management of a Trust

Trusts are managed by their trustees. Though certain rules, liabilities, rights, powers and disabilities of the trustees have been laid out under the Indian Trusts Act, no specific rules/ provisions have been made regarding the management of trusts. Thus, specific provisions may be made in the 'trust deed' or the trustees should themselves agree to a code of conduct for the smooth and efficient functioning of the Trust. A Trust must make rules with regard to

a. holding meetings;
b. quorum for meetings;
c. chairing meetings;
d. adopting resolutions;
e. nature of the functions / businesses to be carried out by the trust;
f. delegation of functions; and
g. fixing accountability.

2.2.3 Accounts & Audit

A Trust must maintain proper and regular books of accounts, to record its financial transactions. The generally accepted accounting norms should be adopted to make the records transparent. The organisation must have management policies with regard to:

a. Maintenance of the bank accounts of the Trust;
b. Investment of its assets;
c. Maintenance of the books/records of account (including petty cash book, main cash book, general ledger, journal, investment registers, fixed asset register, stock register) and compliance with the accounting standards;
d. Maintenance of the records of the trust;
e. Preparation of financial statements;
f. Compliance of accounting standards; accounting standards relate to the codification of generally accepted accounting principles. The main purpose of accounting standards is to provide information to the users as to the basis on which the accounts have been prepared. The objective of setting standards is to bring about uniformity in financial reporting and to ensure consistency and comparability in the financial statements; and
g. Periodic audit of financial records: An audit is a systematic review of the financial transaction of a Trust. It involves an examination of the validity of supporting

documents, certification of the financial statements and submission of an audit report. Every Trust needs to get its books of accounts audit by a qualified chartered accountant, who would be appointed by the governing body of the Trust by passing a resolution.

2.2.4 Investment of Funds

There are various apprehensions regarding investment of the funds of a Trust. A Trust deed normally lays down the manner in which Trust funds shall be invested and trustees must invest the Trust funds primarily in the manner thus prescribed. However, a public charitable Trust claiming exemption under certain sections of the Income Tax Act needs to invest its funds in certain specified assets. A charitable Trust is required to invest or deposit its funds in the modes or forms specified under Section 11(5) of the Income Tax Act. Besides, it must not hold any shares in a company (other than a government company or corporation). If any part of its funds is not so invested, the exemption under Section 11 would not be allowed.

Private trusts are required to invest their funds in the manner directed in the Trust deed, otherwise the trusts are free to invest their funds in any manner whatsoever. Such trusts, have wide scope for improving their resources by making prudent and creative investments. However, the organisation must have a policy on the investment of its funds. This holds significance for the functioning of MFIs that sometimes have a surplus of resources that need to be invested (at least temporarily) in order to optimise returns.

2.2.5 Acceptance of Foreign Contributions

The provisions regulating the acceptance of foreign contribution by the societies for charitable purposes would be applicable to the trusts using the funds for similar purposes. The trusts would also need to undergo all the required processes and procedures that a society needs to undergo in order to avail the foreign contribution. The details of these processes and procedures are provided in the earlier part of this report. (Refer to Section 2.1.6)

2.2.6 Taxation

Trusts registered under Indian Trust Act, 1882 are also subject to same rules and regulations as discussed under Section 2.1.6 of the report.

2.2.7 Determination of Trusts

The dedication of property to a Trust for charitable or religious purpose is permanent. Thus once a Trust is created for religious or charitable purpose it is permanent and cannot be revoked or reversed or terminated. MFIs registered as trusts and though having charitable purpose, they are registered as private trusts. A private Trust will terminate in the following circumstances:

a. when the purpose for the trust is completely fulfilled;
b. when its purpose becomes unlawful;
c. when the fulfillment of its purpose becomes impossible by destruction of Trust property or by otherwise; and
d. when the Trust being revocable, is expressly revoked.

Thus the Trust would be determined when all the beneficiaries transfer their interests. In such an event, the Trust property shall not be available for fulfillment of its purpose and the Trust will stand dissolved. Similarly, a Trust declared for a specified period of time, will be determined on the efflux of the time period. MFIs registered as trusts would need to have their terms of determination clearly spelt out as part of the Trust deed to deal with any such eventuality.

2.2.8 Compatibility with the insurance regulations

In its current shape, IRDA regulations do not recognise the trusts as an agent to deliver the services related to insurance. While the NGOs registered as societies are clearly allowed to carry on the insurance function as an agent, there is no mention of NGOs registered as trusts for this purpose. However given the development role of many of the NGOs registered as trusts, it is quite likely that the proposed legislation on micro-insurance would include the trusts also as the agent for the micro-insurance service delivery.

2.2.9 Advantages and Disadvantages of registration under the Indian Trusts Act

The advantages and disadvantages related to MFIs registered under the Societies Act are equally applicable to trusts. However while IRDA recognises NGOs registered as societies as a distribution channel for the micro-insurance, there is no such clarity with regard to trusts. Apart from this, private trusts may be even more unsuitable as the tax exemption extended to societies may apply to such trusts only to the extent the Income Tax department accepts their activities as being charitable.

Advantages

i simple process of registration;
ii simple record-keeping and even simpler regulations;
iii low possibility of interference by the regulator; and
iv (largely) exemption from tax due to the overtly charitable nature of operations;

Disadvantages

i as a charitable institutional form, in essence inappropriate for the for-profit, financially sustainable strategic goal of microfinance operations;

ii tax-exemption for surpluses can be (and is) challenged on the question of whether provision of microfinance services is a charitable activity;

iii no system of equity investment or ownership, thereby, making it less attractive for commercial investors interested in microfinance;

iv commercial investors generally regard the investments in such entities risky primarily on account of their lack of professionalism and managerial practices and are, therefore, reluctant to commit large volumes of funds to such MFIs;

v In accordance with Section 45S of the RBI Act, 1934, no unincorporated bodies are allowed to accept deposits from the public. Organisations registered under the Societies Registration Act and the Trust Act are considered unincorporated bodies. Therefore, according to the law, they are not even allowed to collect savings from their clients; and

vi also vulnerable to the implication under the money lenders (prevention of usurious interest rates) acts of various state governments as the status of microfinance is debatable as a charitable activity. A discussion on the Moneylenders' (Prevention of usurious interest rates) Act is annexed with the report in Annex I.

2.3 NOT-FOR-PROFIT COMPANIES REGISTERED UNDER SECTION 25 OF COMPANIES ACT, 1956

An organisation given a license under Section 25 of the Companies Act 1956, is allowed to be registered as a company with limited liability without the addition of the words 'Limited' or 'Private Limited' to its name. It is also eligible for exemption from some of the provisions of the Companies Act, 1956. For companies that are already registered under the Companies Act, 1956, if the central government is satisfied that the objects of that company are restricted to the promotion of commerce, science, art, religion, charity or any other useful purpose; and the constitution of such company provides for the application of funds or other income in promoting these objects and prohibits payment of any dividend to its members, then it may allow such a company to register under Section 25 of the Companies Act.[18]

2.3.1 Registration

As stated earlier, both a fresh entity and an association as well as an existing company are entitled to be registered as a Section 25 company provided they follow certain procedures and fulfill requirements as provided in the guidelines. The procedure for the registration as Section 25 for both the above types of organisations is discussed below.

[1] Henceforth referred to as Section 25 companies.

2.3.1.1 Registration of New Associations

Such associations need to apply to the Regional Director, Company Law Board of the region with a covering letter along with the following documents

a. Draft Memorandum and Articles of Association of the proposed company in three copies. The memorandum and articles should be typewritten and then printed after having been approved by the Regional Director. No stamp duty is payable on the memorandum and Articles of Association of a company to be registered under these provisions.
b. List of names, addresses, description and occupation of the promoters in three copies.
c. List of companies, associations and other institutions in which promoters of the applicant company are directors or hold responsible positions, with description of positions held.
d. List of members of the proposed Board of Directors.
e. Declaration in the prescribed format signed by
   - An advocate of Supreme Court or of the High Court, or
   - An attorney or pleader entitled to appear before the High Court, or
   - A Chartered Accountant with a whole-time practice in India, or
   - A Company Secretary with a whole time practice in India,

   on a non-judicial stamp paper of appropriate value.
f. Copies of accounts, balance sheet and reports on the working of the association for the last two financial years (for one year only if the association has functioned for less than two years), in triplicate.
g. Statements of assets and liabilities.
h. Sources of income of the proposed company and estimate of annual income and expenditure.
i. A note on the work already being done by the association and work proposed to be done after being registered under Section 25.
j. Grounds in brief for making application under Section 25.
k. Declaration (in the prescribed format) signed by each of the applicants.

Within a week of making application to the Regional Director, a notice declaring the intention of registering a not-for-profit limited liability company with the name of the proposed company, is required to be published in the prescribed format. It should be published in one English, and one vernacular newspaper of the area where the registered office is situated. A certified copy of the notice should be filed with the Regional Director. The application should also be accompanied by a demand draft of Rs 500 drawn in favour of “Pay and Accounts Officer, Department of Company Affairs”. The fee may also be paid through a treasury challan at specified branches of the Punjab National Bank.

The license is granted by the Regional Director after scrutiny of the applications and considering the recommendation of the Registrar made on the application. The Regional Director may direct the company to incorporate in its memorandum or articles or both, such conditions of the license as may be specified by the Regional Director in this regard. A copy of the application with all enclosures and accompanying papers should be sent to the Registrar of Companies of the State where company proposes to situate its head office/registered office.

After the draft memorandum and articles have been approved, the association should apply to the Registrar of Companies concerned, for its registration as a company along with printed copies of the memorandum and articles, required forms (Form nos. 1, 18 and 32) and also produce the license granted by the Regional Director along with the necessary registration fee of Rs 50 and filing fee of Rs 10 per document. As per the opinion of the department, since the quantum of fee payable has been fixed irrespective of the amount of capital, the fee payable at the time of increase of capital will also be Rs 50 only. The Registrar, after scrutinising the documents and finding them in order, shall issue the Certificate of Incorporation in Form No 1 as per Regulation 16(1) f the Companies Regulations, 1956.

2.3.1.2 Conversion of Companies already Registered

Such companies should apply to the Regional Director by a covering letter along with

a. Memorandum and Articles of Association.
b. List of names and addresses, description and occupation of directors, managers or secretary.
c. Name of companies, association and of other institutions, in which the directors of the applicant company are directors or hold any responsible position (with description).
d. Three copies each of profit and loss account, balance sheet, annual report of Board of Directors and audit report of the company for each of the last two financial years (if company has been in existence for less than two years, documents relating to one year may also be submitted).
e. Assets and liabilities of the company.
f. Estimate of expenses and sources of income.
g. A note on work already done by the association and works proposed to be done after being registered under Section 25.
h. Grounds, in brief, for making application under Section 25.
i. Declaration (in prescribed format) signed by each of the applicants.
j. Certified copy of notice published in newspaper. This notice should be published in one English, and one vernacular newspaper of the area where the registered office is situated within one week after or before making the application.

The application needs to be accompanied with a demand draft worth Rs 500 as discussed in the preceding section. The license is granted by the Regional Director after the scrutiny of the applications and considering the recommendation of the Registrar made on the application. The Regional Director may direct the company to insert in its memorandum or its articles or partly in one or partly in the other, such conditions of the license as may be specified by the Regional Director in this regard.

After receipt of the necessary approval under Section 25 the approved memorandum and articles should be printed without stamping as stamp duty is exempted. Thereafter they should be filed with the Registrar along with required forms (Form no 1, 18 and 32) for incorporation along with a registration fee of Rs 50 and filing fee of Rs10 per document. The Registrar then issues a certificate of incorporation to the association or club, as per Regulation 16(1) of the Companies Regulations, 1956.

2.3.2 Privileges and Exemptions

According to Section 25 (2), registration having been granted to an association, it enjoys all the privileges of a limited company and is subject to all the obligations except where the provisions of Section 25 (or through general or special order of the central government), certain exemptions are granted. These exemptions primarily relate to provisions for the appointment of directors, publication of name and address of the company, holding of annual general meetings, quorum of the board meeting, disclosure of interests by directors. The most important of the exemptions relates to the disclosure of annual returns for income tax and appointment of the company secretary. Section 25 companies are exempted from these two provisions that apply to other types of companies. The details of these exemptions are provided in the Annex 2.

Further, in January 2000, the RBI issued a notification that Sections 45 IA and IC[19] of the RBI Act will not apply to companies registered under Section 25 of the Companies Act. This exemption effectively means that Section 25 companies can take up the activity of lending without the permission of or registration with the RBI, provided these are within the definition of microfinance – loans to business enterprises up to Rs 50,000 and loans for dwelling units up to Rs1,25,000. Deposit taking is, however, not permitted without such registration with the RBI.

2.3.3 Taxation

Being an entity engaged in not-for-profit activities and not sharing its surplus amongst shareholders, Section 25 companies are exempt from paying tax under Section 12(1) of the Income Tax Act. This is a major benefit for Section 25 companies. In order to avail

[19] These sections of RBI Act deal with the requirements that the companies involved in the business of financial services need to have.

this exemption, organisations need to apply to the Commissioner of Income Tax. The process of availing this benefit is discussed in detail in the Section 2.1.7 of this report.

2.3.4 Compatibility with Insurance Related Regulations

IRDA allows any company registered under the Companies Act 1956 to become a corporate agent of the insurance company registered with IRDA. Section 25 companies under this provision are allowed to become corporate agents of one life and/or one non-life insurance company. They need to follow all the other relevant regulations related to IRDA.

2.3.5 Advantages and Disadvantages of Registering MFIs as Section 25 Companies

Section 25 companies are subject to some of the problems similar to those faced by societies and trusts. However they have certain advantages also. These issues are discussed as under:

Advantages

i Exemption from Income Tax: Section 25-1A of the Companies Act, 1956, mentions as objectives of charitable Section 25 companies as "the promotion of commerce, art, science, religion, charity or any other useful object". This works as a great advantage for MFIs.

ii Leveraging Capacity: Having a Section 25 company adds to the legitimacy of the institution. This also adds to the credibility of the commercial FIs who are willing to lend to the sector.

iii Easier processes and low regulator interference: As discussed in the preceding sub-sections, Section 25 companies have relatively easier processes to register and they need to comply with very few regulatory requirements. They also need not register with RBI unlike NBFCs. This makes the functioning of the organisation very easy.

Disadvantages

i Deposit mobilisation: The same restrictions as for societies/trusts apply to deposit mobilisation for Section 25 companies.

ii Not an attractive option for equity mobilisation: Being a not-for-profit entity prohibits the Section 25 companies from distributing dividend. Therefore, these entities find it difficult to attract equity investors, even some social investors, to invest equity funds with them. Also the exit route for investors is not smooth since another investor willing to forgo the possibility of a dividend return on the investment must be found.

iii Lack of clarity on ceiling: Although microfinance defined by RBI provides for financial services of very small amounts, the RBI instructions exempting Section 25 companies from registration and reserve requirements for NBFCs stipulate that loans should not exceed Rs 50,000 for non-housing purposes and Rs125,000 for housing purposes.

2.4 NON-BANKING FINANCE COMPANIES

NBFCs have played an important role in the Indian financial sector for a long time, fulfilling the gap in the demand and supply of financial services, particularly from small clients. What has promoted the growth of NBFCs is their localised presence, a higher level of customer orientation than banks and lower documentation requirements albeit at higher interest rates for borrowers. Conversely, depositors earn substantially higher rates of interest as compared to the traditional savings instruments of banks. In this way, NBFCs are able to attract a large volume of deposits from the general public. Lower entry barriers and high returns (in relation to banks) from the NBFC business attract lots of entrepreneurs. Many such companies have been unable to service their debt obligations due to ineffective asset-liability matching and spectacular collapses, like CRB Caps in Ahmedabad and Century Consultants in Lucknow, which has resulted in considerable loss of public confidence in NBFCs' services.

Recognising the importance of NBFCs in the Indian financial sector and with the objective of integrating these with the financial mainstream, RBI started to regulate them from 1996. These measures include mandatory registration of companies offering financial services with the RBI, compulsory credit rating of deposit taking NBFCs and imposition of prudential norms.

2.4.1 Definition

As per the Section 45-I of the RBI Act, an NBFC is a company which carries on any of the following activities as its business or part of its business:

- Lending;
- Receiving of deposits (as the principal business);
- Acquisition of shares, stocks or other securities;
- Hire-purchase or leasing;
- Insurance;
- Chit funds; and
- Lotteries

As per this definition, if a company undertakes microfinance, it automatically becomes an NBFC and all related regulations apply.

Pre-requisites for carrying on the business of an NBFC: Under Sub-section 1 of Section 45-IA of the RBI Act, no NBFC can commence or carry on the business of a non-banking company without complying with the following two essential pre-requisites:

a. Obtaining a certificate of registration from RBI; and
b. Having Net Owned Funds (NOF) – shareholder equity + internally-generated reserves of Rs 200 lakh. This limit was earlier Rs 25 lakh only, it has now been increased to Rs 200 lakh by RBI. Vide notification no DNBS 132/CGM (VSNM)-99, dated 20-4-1999, the RBI specifies the "net-owned fund" (NOF) to be Rs 200 lakh, for an NBFC which commences the business of an NBFC after April 21, 1999.[20] Thus, this specification of higher "(NOF)" is not applicable to NBFCs that commenced business before April 21, 1999.

These requirements are cumulative and not alternative. As such, if a for-profit company wants to carry out microfinance operations, it must comply with the above requirements. Though RBI prescribes a set of compliance norms (prudential and non-prudential) for all NBFCs, these are more rigorous (prudential) for NBFCs accepting public deposits. However prudential norms are not applicable to the companies which are not accepting public deposits. It is, therefore, important first to understand the meaning of public deposits.

The definition of public deposits given in the RBI Act, 1934 is exclusive rather than inclusive. Section 45-I (bb) of the Act defines 'deposits' in general terms to include any receipt of money by way of deposit or loan or in any other form'. The Act then excludes the following items from the definition:

a. Amounts raised by way of share capital;
b. Amount contributed as capital by partners of a firm;
c. Amounts received from scheduled banks, cooperative banks or other notified financial institutions;
d. Amounts received in the ordinary course of business, by way of, security deposits, dealership deposit, earnest money or advance against orders for goods, properties or services;
e. Amounts received from registered moneylenders, provided that such moneylender is not a company; and
f. Amounts received by way of subscription in respect of a chit.

Paragraph 2(1) (xii) of the directions also excludes certain deposits from the definition of public deposits. These are amounts received

[20] However this specification of higher "net-owned fund" shall not be applicable to such company whose application for certificate of registration under Section 45-IA of the said act is submitted to Reserve Bank of India on or before April 20, 1999.

a. from the central or any state government or under its guarantee;
b. from a local authority;
c. from a foreign government or any foreign citizen, authority or person;
d. from institutions like LIC, IDBI, ICICI, IFCI, ADB, IFC or any other institutions specified by RBI;
e. from one company to another company;
f. as subscription to any shares, stocks, bonds or debentures;
g. from a director/shareholder of a private company, or a private company which has become a public company under Section 43A of the Companies Act, subject to the director/shareholder furnishing a declaration to the effect that the amount has not been given out of borrowed funds or from the amounts accepted from others;
h. from mutual funds governed by the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996;
i. received as hybrid debt or subordinate debt the minimum maturity period of which is less than 60 months;
j. from a relative of a director of an NBFC; and
k. received by issuance of commercial paper, in accordance with the guidelines issued by the Bank vie circular no IECD 3/08.15.01/2000-2001 dated October 10, 2000.

Barring these exclusions, all receipts of an NBFC come under the category of public deposits.

2.4.2 Registration

As mentioned in the preceding sub-section, all NBFCs need to get registration with RBI for carrying on their business. In order to get such registration as NBFCs, MFIs need to fulfill the following two basic criteria:

a. should be registered as a company under the Companies Act, 1956; and
b. should have a minimum "net-owned fund" of Rs 200 lakh (if not already registered on 20 April 1999).

If the MFI meets the above two criteria, it can file an application for registration with the RBI's Department of Non-Banking Services. The procedure for obtaining registration is described in Table 2.4.1[21]

[21] Source: Taxmann's Statutory Guide for Non-Banking Financial Companies, An authorised publication of Reserve Bank of India (2004).

Table 2.4.1

Procedure for registering an NBFC with RBI

Process	Details
Submission of application	Application should be made in the form prescribed by RBI, to be filled in accordance with the instruction contained in the form. Documents required to be enclosed should also be prepared in accordance with the instructions and should be attached to the application.
Where to submit the application	To the regional RBI office under whose supervision the company's registered office is situated.
Processing by RBI	RBI will ensure that the conditions spelt out in the sub-section 45-IA are fulfilled. These conditions broadly cover the following areas: • Capacity of the NBFC to meet the creditor's claims in full, when the claims accrue. • Conduct of the affairs of the NBFC in a manner not detrimental to the interests of depositors. • General character of the management of the NBFC is not prejudicial to the public interest or the interest of its depositors. • NBFC has adequate capital structure and earning prospects. • The grant of certificate serves the public interest. • The grant of certificate will not be prejudicial to the operation and consolidation of the financial sector consistent with monetary stability, economic growth or other relevant factors. • Any other condition which, in the opinion of RBI, is necessary to ensure that the business of the NBFC is not prejudicial to the public interest or the interest of depositors.

Process	Details
Issue of Certificate	RBI will thereafter grant a certificate of registration, with or without specified conditions.
Cancellation of registration	RBI can cancel the registration in the following situations [Section 45-IA (6)]: • When the NBFC ceases to carry on business. • When the NBFC fails to comply with any condition specified by RBI while granting certificate of registration.(a) • When the NBFC is, at any time, found to have failed to fulfil any of the conditions mentioned in *'Processing by RBI'* above. (b) • When the NBFC fails to comply with any directions issued by RBI. • When the NBFC fails to maintain accounts in accordance with any law, or with any direction or order issued by RBI. • When the NBFC fails to submit or offer for inspection its books of accounts and other relevant documents when demanded by RBI. • When the NBFC has been prohibited from accepting deposit by an order of RBI, and that order has been in force for not less than three months.
Procedure for cancellation of registration	The NBFC should be given a reasonable opportunity of being heard. Where action for cancellation is proposed on the grounds a and b as stated above, the NBFC must generally be given an opportunity by RBI to take the necessary steps to comply with the conditions, except in cases where RBI is of the opinion that the delay in cancelling the certificate of registration shall be prejudicial to the public interest or the interest of depositors or the NBFC.
Appellate remedy	If the application for registration is rejected by RBI, or if the certificate of registration is cancelled by RBI, the company can prefer an appeal to the central government within 30 days from the date

Process	Details
	on which the order was communicated to it. The decision of the central government on the appeal, if any, filed by the NBFC shall be final. Where no appeal has been preferred by the NBFC within the stipulated time, the decision of RBI shall be final.
Utilisation of funds during the interregnum	Till such time as the certificate of registration is granted by RBI, the NBFC can keep its capital funds invested in any type of deposits with a bank. Investment in any other type of securities will invite penal action.

Source: Taxmann's Statutory Guide for Non-Banking Financial Companies, An authorised publication of Reserve Bank of India (2004).

2.4.2.1 Acquisition of an NBFC

Many societies/trusts working in the area of microfinance are buying existing NBFCs. They also transfer their relevant assets and liabilities to these entities in order to transform into a more evolved legal entity. Since the provisions laid down in the Companies Act, 1956, govern the transfer of ownership of NBFCs, it is increasingly being viewed as an easier option for the MFIs. It would be worth mentioning here that in case the existing NBFC was registered before April 20, 1999, the changed provisions on net-owned funds would not apply to them.

2.4.3 General Compliance Requirements

All NBFCs, being companies registered under the Companies Act, have to fulfill compliance relating to the Board of Directors, Share Capital, Management Structure, Audits, Meetings, maintenance as well as publication of books of accounts and general conduct as per the requirements of the Companies Act 1956. In addition, they have to fulfill the specific requirements of RBI. Some of the general compliance requirements are set out below.

2.4.3.1 Submission of Returns

All NBFCs need to report to RBI on a regular basis. Table 2.4.2 below summarises the returns to be submitted to RBI along with their due dates.

Table 2.4.2

Schedule for submission of returns by NBFCs

Nature of return to be submitted	Due date
Audited balance sheet as on the last date of the financial year and profit and loss account in respect of that year, as passed by the company in its general meeting, together with a copy of the report of the Board of Directors	Within 15 days of the general meeting
Auditor's report to the Board of Directors, together with a certificate from the auditor to the effect that full amount of liabilities to the depositors, including interest payable, is properly reflected in the balance sheet, and the company is in a position to meet the amount of such liabilities to the depositors	Along with the audited balance sheet
Information on financial position, as specified in the First Schedule (Return NBS 10) to the Directions	Due date specified in the First Schedule (Return NBS 1)
Half-yearly returns in the format specified (Form No NBS 2)	Within three months of the expiry of the relevant half-year ending in September or March
Changes in - Postal address/ tel no/ fax no of the registered office of the company - Names and residential addresses of the directors of the company - Names and designations of the principal officers of the company - Specimen signatures of the officers authorised to sign on behalf of the company	Within one month from the occurrence of the change

Source: Taxmann's Statutory Guide for Non-Banking Financial Companies, An authorised publication of Reserve Bank of India (2004).

2.4.3.2 Minimum Investment Norms for Liquidity

Not less than 15 per cent of their deposits should be invested by NBFCs in specified securities and approved securities (government securities and bonds guaranteed by the government).

2.4.3.3 Opening and closing of branches

NBFCs are required to notify RBI of their intention to open branches. On receipt of such advice the RBI may, after recording relevant reasons, reject such a proposal and communicate this to the NBFC. If no notice of rejection is communicated to the NBFC within 30 days of receipt of such a proposal, the NBFC may proceed to open the branch.

No NBFC shall close its branch/office without publishing such intention in any one national newspaper and in one vernacular newspaper in circulation in the relevant place and without advising RBI, before 90 days of the proposed closure.

2.4.3.4 Prudential Norms

Section 45JA of the RBI Act empowers RBI to determine policy and give directions to all NBFC having a net-owned fund of Rs 25 lakh and above and accepting/holding public deposit, relating to

a. Income recognition and accounting standards;
b. Provision for bad and doubtful debts;
c. Capital adequacy based on the risk weight of assets;
d. Credit conversion factors for off-balance sheet items; and
e. Deployment of funds

Important prudential norms for NBFCs are summarised in Table 2.4.3.

Table 2.4.3

Prudential Norms for NBFCs

Parameters	Provisions
Capital adequacy	Every NBFC is required to maintain a capital adequacy ratio of 15% (in case they are also receiving public deposits), consisting of Tier I and Tier II Capital.[22] The total of Tier II Capital should not be more than 100% of Tier I capital. However there is no minimum bar on capital adequacy if the NBFC is not receiving public deposit.
Prohibition on loans	An NBFC is prohibited from lending against its own shares. Also if an NBFC has defaulted on its deposit obligations, it is prohibited from lending.
Restrictions on investments	An NBFC which is accepting public deposits can invest a maximum of 10% of its NOF in land and building (except for its own use), and 20% of its NOF in unquoted shares of companies other than subsidiaries and companies in the same group.
Ceiling on concentration of credit/investments	Lending to a single borrower – 15% of NOFLending to a single group of borrowers – 25% of NOFInvestment in shares of another company – 15% of NOFInvestment in shares of a single group of companies – 25% of NOF
Accounting requirements	The NBFCs have to comply mainly with the following accounting requirements 1. Income recognition 2. Income from investments 3. Accounting standards 4. Asset classification 5. Provisioning requirements 6. Disclosure in the balance sheet

[22] Tier I and Tier II capitals form part of the net worth of the organisation. Tier I capital means the owned fund (sum total of paid-up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account, capital reserve representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of assets and accumulated surplus or deficit) reduced by investment in shares of other NBFCs and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten percent of owned fund. Tier II capital includes preference shares other than those which are compulsorily convertible into equity; revaluation reserves at discounted rate of 55%; general provisions and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of one-and-one-fourth per cent of risk weighted assets; hybrid debt-capital instruments and subordinated debt, to the extent the aggregate does not exceed Tier I capital.

Audit committees	All NBFC having assets of Rs 50 crore and above as per the last audited balance sheet shall constitute an Audit Committee, consisting of not less than three members of its Board of Directors
Exposure to capital market	Every NBFC holding public deposits of Rs 50 crore and above shall submit a quarterly return within one month of expiry of the relative quarter in prescribed format (Format NBS-6) to the Regional Office of the Department of Non-Banking Supervision of the RBI.

Source: Taxmann's Statutory Guide for Non-Banking Financial Companies, An authorized publication of Reserve Bank of India (2004).

All these prudential requirements are however not applicable to all NBFCs. If the NBFC is not accepting public deposits then it is exempted from the prudential requirement on capital adequacy and ceiling on concentration of credit/investments.

2.4.4 Specific compliance requirements relating to NBFCs accepting public deposits

Since the major objective of NBFC regulations is to maintain the confidence of the general public through the protection of their deposits in NBFCs, RBI has stipulated specific compliance requirements for NBFCs accepting/maintaining public deposits.

2.4.4.1 Minimum Credit Rating

An NBFC must obtain minimum investment grade rating for fixed deposits from any of the approved credit rating agencies at least once a year, after being in operation for not less than two years. The approved credit rating agencies and minimum credit ratings are as indicated in Table 2.4.4. Rating agencies use different sets of standards for ascertaining the creditworthiness of FIs. Some of the most common areas universally looked at by these agencies include the capital adequacy, asset quality, liquidity, management strength, profitability, efficiency and corporate governance. If an FI has performed well along all the above parameters; it may attain an investment rating grade from the agency. However a number of such parameters are subjective also; therefore a lot may depend on the methodology and the quality of the risk assessment team. A short note on the rating principle and framework is provided in Annex 3.

Table 2.4.4

Investment Grade Ratings of Approved Rating Agencies for NBFCs

Name of the Agency	Minimum investment grade rating
The Credit Rating Investment Services of India Ltd (CRISIL)	FA – (FA Minus)
ICRA Ltd	MA – (MA Minus)
Credit Analysis and Research Ltd (CARE)	CARE BBB (FD)
FITCH Ratings India Private Ltd	tA – (ind) (FD)

Source: Taxmann's Statutory Guide for Non-Banking Financial Companies, An authorised publication of Reserve Bank of India (2004).

Any upgrade or downgrade of the credit rating must be intimated to RBI within 15 working days of such change.

2.4.4.2 Ceiling on quantum of deposits

Table 2.4.5 sets out the ceiling on public deposits for Loan Companies[23]

Table 2.4.5

Ceiling on deposit for Loan Companies

Category of Loan Company	Ceiling Limit
Having NOF of more than Rs 200 lakh[24] and above a. Not complying with all the prudential norms, and not having minimum investment grade rating b. Complying with all the Prudential Norms and having minimum investment grade rating	Cannot accept any public deposit

[23] As per the directives of RBI on the NBFC Acceptance of Public Deposits (Reserve Bank) Directions, 1998, dated 31st January 1998; Loan Company is the one which is a financial institution carrying on as its principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own, but does not include an equipment leasing company or a hire-purchase finance company.

[24] As mentioned in the preceding sub-sections of the report, Vide notification no DNBS 132/CGM (VSNM)-99, dated 20-4-1999, the Reserve Bank of India specifies the "net owned fund" to be Rs200 lakh, for an NBFC which commences the business of a non-banking financial institution on or after 21st April 1999. This specification of higher "Net Owned Fund" shall not be applicable to such company whose application for certificate of registration under section 45-IA of the said act is submitted to the Reserve Bank of India on or before 20th April 1999.

Category of Loan Company	Ceiling Limit
(i) with capital adequacy ratio of at least 15%	150% of NOF
(ii) With capital adequacy ratio of 15% but having credit rating, AAA	Amount outstanding at the close of business on December 18, 1998 or 150% of NOF whichever is more.
(iii) With capital adequacy ratio less than 15% but credit rating, AA	100% of NOF
(iv) With capital adequacy less than 15% but with credit rating, A	50% of NOF
(v) With capital adequacy ratio less than 15% but credit rating below A	Cannot accept any public deposit

When the credit rating goes below the minimum specified investment grade, the company should

a. Stop accepting public deposits with immediate effect;
b. Report the position to RBI within 15 working days; and
c. Within three years from the date of downgrade of credit rating, reduce the excess deposit to nil, either by repayment of matured deposits or otherwise.

Some other general restrictions on deposits of NBFC are given in Table 2.4.6.

Table 2.4.6

Restrictions and Directions on Deposit Mobilisation

Particulars	Nature of restrictions/directions
Demand deposit	Acceptance or renewal of any public deposit which is repayable on demand is prohibited.
Period of deposit	The period of public deposit should be for a minimum of 12 months and for maximum of 60 months from the date of acceptance or renewal.
Ceiling on rate of interest on public deposit	Rate of interest not to exceed 11% per annum. Interest should be paid or compounded at rests which shall not be shorter than monthly rests.
Brokerage	Brokerage, commission, incentive or any other incentive for public deposit paid to a broker should not be more than 2% of the amount of deposit so collected

Source: Taxmann's Statutory Guide for Non-Banking Financial Companies, An authorised publication of Reserve Bank of India (2004).

2.4.5 Audit and Taxation

Being a company registered under Companies Act, NBFCs need to follow the norms laid down by the Registrar of Companies with regard to auditing. They need to get themselves audited once every quarter by an external auditor. They also need to follow the norms on appointment of auditors as laid down by the Registrar.

NBFCs also need to follow the norms on the taxation as laid down in the Income-Tax Act. They are subject to taxation on their surpluses as per the regulation. In order to obtain the grant funds from foreign sources, they also need to have registration under FCRA. The detailed process of obtaining registration under the FCRA is discussed in Section 2.1.7.

2.4.6 Compatibility with Insurance Regulations

As per the guidelines laid by IRDA and RBI, NBFCs are allowed to participate in the insurance business either by setting up their own business or as agents of an insurance company registered with IRDA. Considering the high capital requirement for setting up an insurance company (Rs 500 crore), the first option is not viable for an MFI. Further, RBI has laid down very strict regulations for NBFCs to carry out the business of insurance as corporate agents of insurance companies. The conditions for the NBFCs registered with RBI who are also doing the insurance business as corporate agent of insurance companies are:

a. The NBFCs should obtain requisite permission from IRDA and comply with the IRDA regulations for acting as 'composite corporate agent' with insurance companies.

b. The NBFCs should not adopt any restrictive practice of forcing its customers to go only for a particular insurance company in respect of assets financed by the NBFC. The customers should be allowed to exercise their own choice.

c. As the participation by an NBFC's customer in insurance products is purely on a voluntary basis, it should be stated in all publicity material distributed by the NBFC in a prominent way. There should be no 'linkage' either direct or indirect between the provision of financial services offered by the NBFC to its customers and use of the insurance products.

d. The premium should be paid by the insured directly to the insurance company without routing through the NBFC.

e. The risks, if any, involved in the insurance agency should not get transferred to the business of the NBFC.

2.4.7 Advantages and Disadvantages of Registration as an NBFC

NBFCs are the only type of MFI falling clearly under the purview of the central bank and subject to prudential regulations. As for-profit companies, they need to pay income tax on their lending operations. In the context of the average MFI, some issues that arise in the matter of registering and operating as NBFCs are:

i Minimum Capital Requirement: The minimum capital requirement (Rs 2 crore) for obtaining a license for an NBFC is high. Given the nature of microfinance in India, and the relatively small size of most MFIs, the mobilisation of funds of this volume becomes a major challenge. This is further complicated as the promoters of such NBFCs are largely societies that are not allowed to make equity investments, lest they lose their tax exemption status.

ii Deposit Mobilisation: NBFCs are not allowed to mobilise deposits unless they complete two years of operations and then obtain an investment grade rating. Such a rating is doubly difficult to get for MFIs – even those with strong portfolios – since the conventional credit rating agencies designated for this purpose by the RBI regard lending to the poor and lending in rural areas as 'inherently risky'. Yet, given the needs of the poor, deposit services are an important element of microfinance and if the low-income clients are denied this service, the very purpose of microfinance is defeated.

iii Foreign Direct Investment and Venture Capital restrictions: The entire financial sector is denied access to venture capital investment and was denied access to external commercial borrowings (ECB) until very recently.[25] Since there are venture capitalists – foreign or domestic – willing to put their money into microfinance, any restriction of this sort places an additional handicap for MFIs. Yet, there are an increasing number of socially responsible international investment funds for microfinance and their investments are effectively barred from India. Foreign direct investment (FDI) in equity is allowed but must be for a minimum of $0.5 million (Rs 2.15 crore today) and cannot exceed 50 per cent of the equity of an NBFC. This means that the MFI must first raise more than Rs 2.2 crore from domestic sources before it can become eligible for foreign equity investment.

However registration with RBI as an NBFC offers advantages also. Some of these advantages are listed below:

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[25] The position on the external commercial borrowing has changed following the introduction of the Finance Bill for the year 2005-06. Microfinance institutions registered as NBFCs are likely, in the near future, to be allowed to have access to external commercial borrowings. The details of this would, however, be known only after the approval of the Finance Bill by Parliament.

i. Investor Confidence: MFIs registered as NBFC because of being recognised and regulated entities for carrying out microfinance operations, provide a higher level of confidence to institutional lenders and banks.

ii. Limited Regulation, if not Accepting Deposits: MFIs registered as NBFCs are subject to nominal regulations if they are not accepting public deposits. Though the general poor clients are deprived of a very important financial service in case deposit acceptance is not allowed, it also brings down the level of regulation significantly if the MFI is not accepting deposits.

iii. Attractive Option for Social Investors: Despite having a very high ceiling for equity investment in NBFCs, they are the most preferred options for social investors interested in the sector. With a regulated structure, NBFCs have a relatively disciplined and professional management. With the equity structure being clearly laid out, the exit route for such investors is also relatively safe compared to other types of MFIs. This factor also helps them in placing their donated equity with the NBFC. Considering the disclosure norms that such NBFCs need to follow on various matters, the willingness of such investors to put their funds increases significantly. (However such institutions would need to have necessary clearance/approval under FCRA, details of which have been discussed under Section 2.1.7).

iv. Upscaling of Operations: With a regulated set-up, disciplined and professional management and a high level of investor confidence, it becomes far easier for the MFIs to upscale their operations. The examples of the MFIs who have converted during the last few years into NBFCs clearly point to this.

2.5 NIDHI COMPANIES

Section 620 of the Companies Act allows for the formation of a special type of company called ‘Nidhi’ company also known as ‘Mutual Benefit Society’. Certain provisions of the Companies Act have been modified under this section. Accordingly, provisions on the service of documents, issue of additional capital, annual returns, dividends, loans and remuneration to directors and winding up processes have been modified for companies recognised as Nidhi or Mutual Benefit Society.

2.5.1 Acceptance of Deposits

Companies registered under this section will have all clients as members of the company. They are allowed to accept deposits so long as these are *from their members only* and to grant loans of up to 50 per cent of the market value of property with registered mortgages in favour of the company or up to 100 per cent of the value of jewellery, fixed deposits or government securities physically deposited with the company. The restrictions and relaxation to the Nidhi companies in terms of acceptance of deposits is provided as under[26]

Restrictions/Procedures:	• Should not accept or renew any public deposit except from its shareholders. • Deposits from shareholders should not be in the nature of current account (savings bank accounts are not prohibited). • Interest rate on deposits should not exceed 14 per cent per annum, and interest can be paid or compounded at rates which shall not be shorter than monthly rests. • Receipts in the prescribed manner must be furnished to depositors. • Must maintain the register of deposits in the manner laid down in the directions. • Should not pay any brokerage/commission/incentive/any other benefit, to any person for public deposits collected by that person. • Should not issue any advertisement in any form and in any media, for inviting or causing to invite deposits from its shareholders. • Security deposits received from employees should be deposited in a scheduled bank or post office in the joint names of the employee and company. The amount should not be withdrawn without the consent of the employee. The amount shall be repayable to the employee along with the interest, unless such amount or any part thereof, is liable to be appropriated by the company for any failure on the part of the employee for due performance of duties. • Submission of returns/documents to RBI as required in the directions.
Relaxations relative to NBFC rules[27]	The requirements laid down in the direction on the following aspect (and also discussed in the preceding section of the report) would not apply: • Minimum credit rating • Prohibition on accepting demand deposits

[26] As per the directives of RBI on the NBFC Acceptance of Public Deposits (Reserve Bank) Directions, 1998, dated January 31, 1998.

[27] Provision laid down vide Notification no DNBS 164/CGM (CSM)-2003, dated 8 January 2003

	- Ceiling on quantum of deposits - Accepting deposits only for a period of at least 12 months but not exceeding 60 months - Regularisation of excess deposits - Renewal of public deposits - Payment of interest on overdue deposits - Joint deposits - Specification of prescribed particulars in application for soliciting deposits - Issue of advertisement and statement in lieu of advertisement - General provision regarding payment of public deposits - Information to be included in Board's report - Safe custody of approved securities

2.5.2 Pros and Cons of Registration as Nidhi Companies

Nidhi companies provide very liberal provisions in terms of compliance with several regulatory norms of the Companies Act and, in the sense that they are allowed to accept deposits from members, represent for MFIs a way around the problem of NBFCs needing to be registered with the RBI and then waiting two years or more to get an investment grade rating. However, the requirement that such companies should lend only against substantial collateral makes them unsuitable as a legal form for MFIs that, by the very nature of their business, must advance loans without collateral. Further, their inability to hold any share capital brings them on par with societies and trusts in other ways. Therefore, they are also subject to the some of the disadvantages of societies and trusts in the matter of fund mobilisation and management.

Further, they have the advantage of being governed by the Companies Act, 1956 and that allows them to be a corporate agent of a life insurance and a non-life insurance company. In case they are functioning as MFIs, they can avail of the FDI facility recently announced by RBI. Apart from this, they can also obtain donated equity from abroad; provided they have necessary clearance under FCRA.

2.6 BANKING REGULATION ACT AS APPLICABLE TO COOPERATIVES

Under the Banking Regulation Act only the State Cooperative Banks, District Central Cooperative Banks and Primary Cooperative Banks (Urban Cooperative Banks — UCBs) are recognised as cooperative banks. The State Cooperative Banks and Central Cooperative Banks form part of the three-tier rural cooperative credit structure promoted by the state governments and NABARD. The relevant category of cooperative banks suitable for MFIs are Primary Cooperative Banks (UCBs).

Definition of banking: The Banking Regulation Act defines banking as "accepting, for the purpose of lending or investments of deposits of money from the public repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise.

Definition of Primary Cooperative Bank: The Banking Regulation Act defines primary cooperative banks as "a primary credit society other than a primary agricultural credit society

a. the primary objective of or principal business of which is the transaction of banking business;
b. the paid up capital and reserves of which are not less than one lakh rupees; and
c. the bye-laws of which do not permit admission of any other cooperative society as a member.

The Act also requires that no cooperative society, other than a cooperative bank, can use the words "bank", "banker" or "banking" in its name and no cooperative society can carry on the business of banking in India unless it uses as part of its name, at least one such word.

Urban cooperative banks are registered under the Cooperative Societies Act of the respective governments. UCBs having a multi-state presence are registered under the Multi-State Cooperative Societies Act (MSCA) 2002. The RBI is the regulatory and supervisory authority of UCBs for their banking operations, while their managerial and administrative aspects remain under the respective state governments (for banks registered under the State Cooperative Societies Act), or the central government (for the banks registered under the MSCA 2002).

2.6.1 Licensing requirement

To be eligible for a license, a UCB needs to be registered either under any of the state cooperative societies' laws or the MSCA 2002 and must have at least 3,000 members and a capital of Rs1 lakh.

2.6.2 Regulation and Supervision of UCBs

Duality of control by the Registrar of Cooperative Societies and the RBI has been pointed out in several studies as one of the primary reasons for most of the problems of the urban cooperative banking sector. The administration aspects of such banks are supervised and regulated by state governments while the banking operations are supervised and regulated by the central bank. This has resulted in overlapping jurisdiction of the state governments and the central bank. Moreover, a clear-cut demarcation of the financial and administrative areas for regulation is almost impossible and acts as an impediment to effective supervision. While the central bank of the country has the wherewithal under the Banking Regulation Act for dealing with crucial aspects of the functioning of commercial banks, in the case of cooperative banks it requires the intervention of the Registrar of Cooperative Societies

Till the early 1990s, apart from basic licensing requirements, RBI did not have much of a role to play in the regulation of UCBs. Following problems in some of these UCBs, some of the prudential norms were made applicable to the UCBs also.

In 1993, RBI introduced Income Recognition and Asset Classification Norms for UCBs. In 1995, the prudential exposure norms for single/group borrowers were also made applicable to them. Subsequently, in a phased time frame, the capital adequacy norms (capital to risk weighted asset ratio) were also applied to UCBs.

The RBI has, from the quarter ended June 2004, extended its off-site surveillance system (OSS) to all non-scheduled UCBs with a deposit size of Rs 100 crore and above. The *OSS reporting system* comprises eight reports. While the periodicity of one return is annual, the remaining seven are required to be submitted at quarterly intervals. Prudential concerns monitored through these returns include aspects relating to solvency, liquidity, capital adequacy, asset quality/portfolio risk profile, connected or related lending and concentration of exposures of the supervised institutions.

Text Box 2

Off-site Surveillance (OSS) System for UCBs

A revised set of off-site surveillance returns were prescribed for scheduled UCBs effective from the quarter-ended March 2004 to obtain relevant information on areas of supervisory concern, strengthen management information systems (MIS) within the scheduled UCBs and to sensitise their managements about the prudential concerns of the supervisory authority and thereby help in self regulation. The content and structure of OSS returns have been modified to reduce the volume of data submission, while enlarging the breadth and depth of information being obtained from UCBs. The UCBs now have to submit eight returns including one annual return from the quarter ended April 2004.

The scope of OSS has been extended to cover non-scheduled UCBs with a deposit base of Rs100 crore and above from the quarter-ended June 2004. The remaining non-scheduled UCBs would be brought under OSS in a phased manner. A revised application software developed by RBI has been installed in all the UCBs covered under OSS enabling them to submit all the regulatory and supervisory returns in electronic format. The accuracy of data submission by UCBs is ensured through validation checks built in the application package. The application package also enables regional offices to capture the data received from UCBs electronically and the data gets replicated in the server installed in the central office over the INFINET.

Source: Report on Trend and Progress of Banking in India, 2003-04 (Reserve Bank of India)

2.6.3 Taxation

Cooperative Banks need to pay income tax as per the provisions of the Income Tax Act. Their income is subject to taxation and any surplus over the expenses, before the payment of dividend and provision to reserves is taxed as per the provisions laid down in the IT Act.

2.6.4 Accounting Related Issues

The accounting principles of cooperative banks are governed by the guidelines and notifications issued by RBI from time to time. Some of the important accounting policies where the RBI has provided its guidelines are: income recognition, asset classification, dividend declaration, provision for bad debts, provision on general reserves, provisions for cash and other statutory reserves (i.e. Cash Reserve Ratio and Statutory Liquidity Ratio), loans to directors of the company and other stake holders, investment into capital market and securities, etc.

2.6.5 Receipt of Foreign Contribution

The issue of receipt of foreign contribution by cooperative banks is governed by the provisions laid down in the FCRA. A cooperative bank can avail foreign contribution upon obtaining necessary clearance from the home ministry and getting itself registered under the FCRA. The details of registration under this Act are discussed under Section 2.1.7 of this report.

2.6.6 Compatibility with Insurance-related Regulation

RBI allows the scheduled and licensed cooperative banks to enter into insurance business but without any risk participation. It has laid down the following conditions for them to follow in order to be part of this:

a. The bank should have a minimum positive networth [real or exchangeable value of paid-up capital and reserves as defined in Section 11 of the Banking Regulation Act, 1949(AACS)] of Rs 50 crore[28] as per the latest RBI guidelines;

b. The bank should have earned net profit for the last three years and should not have any accumulated losses;

c. The gross NPA of the bank should not be more than 10 per cent;

[28] Brought down from the previous ceiling of Rs 100 Crore vide UBD.PCB.Cir. 33/09.116.00/2004-05 dated January 5, 2005

d. The bank should not have violated prudential norms including individual and group exposure norms fixed by RBI/NABARD;

e. The bank should have complied with the instructions issued by RBI/NABARD on loans and advances to directors/relatives, firms etc;

f. No premium collection accounts will be allowed to be opened with the bank and hence, premium collected should be directly paid to the insurance companies;

g. The bank should comply with regulations of IRDA for acting as a corporate agent;

h. The bank should submit an undertaking to the effect that banking business will not in any way get contaminated/affected on account of acting as an agent of insurance companies;

i. The bank should not adopt any restrictive practice of forcing its customers to go in only for a particular insurance company in respect of assets financed by the bank and the customers should be allowed to exercise their own choice;

j. The bank should obtain prior permission from the concerned regional office of RBI before taking up the insurance agency business. The application should be routed through the concerned regional office of NABARD with their recommendation.

2.6.7 Advantages and Disadvantages of Registration as a Cooperative Bank

Advantages

- i Ability to accept demand and time deposits;
- ii Low-capital requirement; and
- iii Access to clearing-house functions

Disadvantages

- i Duality of control. Problems are greater in case the relevant state does not have a MACS Act;
- ii Poor public image of cooperative banks following recent governance and management problems resulting in the failure of a number of such banks; and
- iii On account of these failures it is now also extremely difficult to obtain new licenses from the RBI.

2.7 STATE ACTS ON MUTUALLY AIDED COOPERATIVE SOCIETIES

Many states have brought amendments in their cooperative societies acts thereby making the functioning of cooperatives more autonomous and free from government interference. This act was first passed in the Andhra Pradesh and has functioned as a model for many states which have brought fresh legislations to effect changes in their state cooperative society acts. Some of the states have gone a step further and brought in reforms that have far reaching implications for the functioning of MFIs. Noted among these states are Orissa, Bihar, Madhya Pradesh and Karnataka. The Orissa act allows the SHGs to become members of cooperative societies while the other state acts do not have this provision.

AP Mutually Aided Cooperative Societies' Act (APMACS Act) 1995

AP MACS Act of 1995 has emerged as the popular choice for an organisational form for many MFIs in Andhra Pradesh. This law has also worked as a model act for many other states that have either amended or changed their cooperative societies laws. The acts of other states have more or less similar provisions as the APMACS Act.

2.7.1 Purpose

The purpose of enactment of the APMACS Act, 1995 was to promote institutions which are based on cooperative principles, are self-reliant, accountable and are formed for the fulfillment of the perceived needs of ordinary people. This was in contrast to the AP Cooperative Societies Act, 1964 which encourages the promotion of largely government controlled and dependent cooperative institutions.

2.7.2 Bye-laws

As the objective of the APMACS Act is to promote independent organisations, it prescribes a minimum set of regulations and restrictions. As such, most of the actions of a cooperative society registered under this Act are defined by its bye-laws. The Act requires the bye-laws to be prepared by the members of the society and is generally non-prescriptive about the content of these bye-laws. As per the Act, the bye-laws need to adhere to cooperative principles and contain names, objectives, eligibility as well as termination criteria for membership, division of profit and other details that govern the relationship of the members amongst themselves.

2.7.3 General Body

Subject to the provisions of the Act, the ultimate authority of a cooperative society vests in its general body, which consists of all its members[29]. The cooperative may decide to have a smaller representative general body for more effective decision-making, in case of a large and dispersed membership. The constitution of the representative general body needs to be specified in the bye-laws of the society. The general body of a cooperative

[29] As per the Article 3 of the APMACS Act the membership of a cooperative society shall be voluntary and available without restriction of any social, political, racial or religious discrimination, to all persons who can make use of its services and are willing to accept the responsibilities of membership.

society has the powers to amend bye-laws, election and removal of directors, appointment and removal of auditors, review as well as approval of annual accounts and budgets and dissolution of the cooperative society.

2.7.4 Board of Directors

The executive authority for running the business of a cooperative society is vested in a Board of Directors. The appointment of the Board of Directors of a cooperative society must be in accordance with its by-laws, though the Act prescribes certain qualifications and disqualifications for eligibility. Some of these are:

Qualifications

a. Must be a voting member of the society for at least two years (only for societies in existence for more than two years); and
b. Must have attended two general body meetings of the cooperative society held immediately preceding the elections (only for societies in existence for more than two years).

Disqualifications

a. Members who have, at any time, lost their voting right at any time;
b. A director who absents himself from more than three consecutive Board meetings, without leave of absence; and
c. A director who absents himself from the general body meeting without leave of absence.

2.7.5 Mobilisation of funds

As per the Act a cooperative society may mobilise funds in the shape of share capital, deposits, debentures, loans and other contributions from its members to such extent and under such conditions as may be permissible under the by-laws of the cooperative society

A cooperative society may also mobilise funds in the shape of deposits, debentures, loans and other contributions from other individuals and institutions, to such extent and under such conditions as may be permissible under the by-laws.

A cooperative society shall not accept share capital from the government but may accept other funds or guarantee from the government on such terms and conditions as are mutually agreed upon through a memorandum of understanding

2.7.6 Investment of funds

A cooperative society may invest or deposit its funds in any non-speculative manner outside its business.

2.7.7 Taxation

Like any other cooperative bodies, MACS are also subject to taxation on their annual surpluses as per the guidelines of the Income Tax Act.

2.7.8 External Commercial Borrowing

Following the latest notification of RBI (vide RBI/2004-05/434 A.P.(DIR Series) Circular No. 40), cooperative societies involved in microfinance are eligible to access ECB, provided they have a successful credit history for a period of not less than three years with a scheduled commercial bank; they have a certificate of due diligence on fit-and-proper status of the board/committee of management of the borrowing entity from the designated authorised dealer (AD); and they satisfy the definition of NGO, to be explained by RBI in future. As per the above notification, RBI allows NGOs involved in microfinance activities to access ECB.

2.7.9 Compatibility with Insurance-related Regulations

Mutually-aided cooperative societies can provide insurance coverage to their clients by having a master policy covering all their clients. However they cannot obtain corporate agency of a life or non-life insurance company as they are not incorporated as a company under the Companies Act, 1956.

2.7.10 General administrative guidelines

The Act prescribes guidelines regarding some of the administrative issues also. Some of these are:

a. *Election:* The society will ensure that the Board of Directors is elected before the expiry of the term of the existing directors. These elections need to be in accordance with the by-laws.
b. *Meetings:* The general body needs to meet at least once a year and the board of directors at least once in a year. The by-laws of the society may prescribe a higher frequency of meetings.
c. *Accounts and records:* Some of the important books of account that the Act requires of all cooperative societies are:
    - Cash book;
    - Accounts of assets and liabilities;
    - Accounts of all purchases and sales of goods;
    - Updated register of members;
    - Copies of audit reports and special audits; and
d. *Audit:* A cooperative society may get its accounts audited by a qualified chartered accountant or by any auditor from the office of the Registrar.

2.7.11 Submission of returns

A cooperative society needs to submit the following returns within 15 days of conduct of the annual general meeting:

a. Annual report of activities;

b. Annual audited statements of accounts with auditor's report;

c. List of members at the close of the year under reporting with services provided to each member;

d. Statement on the disposal of surplus or on the allocation of deficit;

e. List of names of directors, their addresses and their terms of office; and

f. Compliance reports relating to audit, special audit and inquiry, if any.

2.7.12 Functions and Powers of the Registrar

The Registrar does not have much power in the case of cooperative societies registered under the APMACS Act. The Registrar cannot refuse registration of a cooperative and its by-laws if they are in consonance with the Act. He also registers all amendments to the by-laws if they are in accordance with the law.

a. *Power to conduct general meetings:* Registrar has the powers to convene general body meeting where a board fails to do so in the stipulated time.

b. *Power to order inquiry:* Registrar can order an inquiry into the affairs of the cooperative on an application of a federation to which the cooperative society concerned is affiliated, or a creditor to whom the cooperative society is indebted.

c. *Recommend dissolution to a tribunal:* Registrar can recommend dissolution of a cooperative society, to a tribunal set up for the purpose by the state government, when he has reasonable grounds to believe that the society has
   - obtained its registration by fraud or mistake;
   - is serving illegal purposes;
   - has wilfully, after notice by the Registrar, violated any of the provisions of this Act or its by-laws;
   - is no longer operating in accordance with principles of cooperation and the provisions of this Act;
   - has not commenced business within two years of the date of registration, or
   - has not carried on business for the past two consecutive years.

2.7.13 Advantages and Disadvantages

Advantages

- i Ease of formation and management;
- ii Ability to accept deposits;
- iii Minimal interference from regulators – unlike cooperative societies formed under the traditional cooperative laws; and
- iv Client centric and therefore mobilise equity also from the clients.

Disadvantages

- i Virtually no regulation. May also encourage risk-taking behaviour by the promoters/managers resulting in the collapse of the institution;
- ii May affect scaling up, as cooperatives are not perceived as a trustworthy organisational form by the formal financial sector; and
- iii Unlike other entities like societies or trusts, they do not have the advantage of tax- exemption.

2.8 PRODUCER COMPANIES

Amendments in the Companies Act 1956 have provided for a new type of company to be owned by the primary producers.

2.8.1 Formation of a Producer Company and its Registration

The Act defines the primary producer as any person engaged in any activity connected with or relatable to any primary produce. As per the proposed amendment, primary produce means

- a. produce of farmers, arising from agriculture (including animal husbandry, horticulture, floriculture, pisciculture, viticulture, forestry, forest products, re-vegetation, bee-raising, and farming plantation products), or from any other primary activity or service which promotes the interest of the farmers or consumers; or
- b. produce of persons engaged in handloom, handicraft and other cottage industries;
- c. any product resulting from any of the above activities, including by-products of such products;
- d. any product resulting from an ancillary activity that would assist or promote any of the aforesaid activities or 'anything ancillary' thereto; and
- e. any activity which is intended to increase the production of anything referred to in sub-clauses 'a' to 'd' or improve the quality thereof.

The Act states the objects of the producer company as

- a. the objects of the producer company shall relate to all or any of the matters as may be prescribed;

b. every producer company shall deal primarily with the produce of its active members for carrying out any of its objects specified in the rules (as prescribed above in (a).

Any 10 or more individuals, each of them being a producer or any two or more producer institutions, or a combination of 10 or more individuals and producer institutions desirous of forming a producer company having its object specified in the rules prescribed under Section 209[30] and otherwise complying with the requirements of this part and the provisions of this part and the provisions of this Act in respect of registration, may form a company as a producer company under the Companies Act.

Application for registration shall be presented to the Registrar of Companies of the state in which the registered office of the producer company is, as stated by the memorandum of association, to be situated

a. the memorandum of the producer company; and
b. its articles, duly signed by the subscribers to the memorandum.

If the Registrar is satisfied that all the requirements of this Act have been complied with in respect of registration and matters precedent and incidental thereto, he shall, within 30 days of the receipt of the documents required for registration, register the memorandum, the articles and other documents, if any, and issue certificate of incorporation under this Act. A producer company so formed shall have the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them and be termed a company limited by shares. On registration, the producer company shall be incorporated as a private limited company provided the provisions of the private limited companies with reference to the limit to the number of members shall not apply to a company registered under this part and that under any circumstances whatsoever, the producer company shall not become a public limited company.

A multi-state cooperative society with objects not confined to one state can also make an application to the Registrar for registration as a producer company. The procedure for the registration of multi-state cooperative society would be same as any other entity. Once registered as a producer company, the provisions of the new Act shall govern the new entity. Also, the Registrar of Companies who registers the company shall forthwith intimate the Registrar with whom the erstwhile multi-state cooperative society was earlier registered for appropriate deletion of the society from its register. All properties and assets, movable and immovable, of, or belonging to, the multi-state cooperative society as on the transformation date, shall vest in the producer company. The same would happen to the rights, debts, liabilities, interests, equity, privileges and obligations of the producer company.

[30] Relates to the requirements for registration of companies.

2.8.2 Share Capital, Special User Rights, Transferability of such Rights and Benefits to Members

The share capital of a producer company shall consist of equity shares and the shares held by a member, shall as far as possible, be in proportion to the patronage of that company. The producers who are active members may, subject to the provision in the articles, have special rights and the producer company may issue appropriate instruments to them in respect of such special rights. The equity shares of the producer companies would be transferable to an active member of the company subject to the prior approval of the board. Any producer company may, subject to such conditions as may be prescribed, issue bonus shares by capitalisation of reserves in proportion to the shares held by the members on the date of such issue. The new Act also provides for the disbursement of dividend and patronage bonus as per the provisions in the article.

2.8.3 Membership, voting rights and general meeting

Every producer company shall in each year, hold, a general meeting, as its annual general meeting (AGM) and not more than 15 months shall elapse between the date of one AGM and that of the next. The various procedures of the AGM of the producer company would be governed by the provisions under the Company Act. However the voting rights of the members would be different from those of the Company Act. In a case where the membership consists solely of individual members, the voting rights shall be based on single vote for every member, irrespective of his shareholding or patronage of the producer company. In a case where the membership consists of producer institutions only, the voting rights of producer institutions shall be based on the basis of the shareholding by such producer institutions during the first year of registration and on the basis of the participation in the previous years' business during the subsequent years. In a case where the membership consists of individuals and producer institutions, the voting rights shall be computed on the basis of a single vote for every member.

2.8.4 Finance, Accounts and Audit

All the provisions of the Companies Act would apply to the producer companies with regard to the financial management, accounts and book keeping and audit. Every producer company shall have internal audit of its accounts by a chartered accountant at such intervals and in such manner as may be prescribed. Every producer company would need to maintain a reserve, in addition to any reserve maintained by it, as may be specified in the articles. In case the producer company does not have a surplus in any financial year for transfer to the reserves, the contribution to the reserve shall be shared amongst the members in proportion to their patronage in the business of that company in that year.

2.8.5 Donations, Loans and Investments

A producer company may by special resolution make donation or subscription to any institution for the purpose of promoting social and economic welfare of producer members or producer or general public but not for any political purpose whether directly or indirectly, subject to such conditions as may be prescribed. It can also provide financial assistance to the members provided that any loan or advance to any director or his relative shall be granted only after the approval of the members in the general meeting. It shall apply its reserves for investment in the approved securities, as may be prescribed, or by a special resolution or for promotion of its objectives by acquiring the shares of another producer company whether by formation of a subsidiary company or by joint venture or in any other manner. Any producer company, either by itself or together with its subsidiaries may invest, by way of subscription purchase or otherwise, shares in any other company, other than a producer company, for an amount not exceeding such proportion of the aggregate of its paid-up capital and free reserves as may be prescribed.

2.8.6 Amalgamation, Merger or Division to Form New Producer Companies

A producer company may, by a resolution passed at its general meeting, decide to transfer its assets and liabilities, in whole or in part, to any other producer company, which agrees to such transfer by a resolution passed at its general or special meeting, for any of its objects. It may also decide to divide itself into two or more new producer companies. Similarly two or more producer companies may, by a resolution passed at any general meeting of its members, decide to amalgamate and form a new producer company or merge one producer company with another. Every such resolution needs to have the approval of a majority of its members with at least two-third of its voting rights attendance. In the case of transfer of whole assets of one producer company to another, the registration of the first producer company shall stand cancelled and that company shall be deemed to have been dissolved and shall cease to exist forthwith as a corporate body. When the two producer companies amalgamate into a new producer company and the new producer company is duly registered with the Registrar, the older producer companies shall be deemed to have been dissolved and shall cease to exist. The amalgamation, merger or division of companies under the this Act, shall not in any manner whatsoever affect the pre-existing rights or obligations and any legal proceedings that might have been continued or commenced by, or against, the concerned resulting company, or merged company, as the case may be.

2.8.7 Taxation

At this point in time, the Income Tax Act does not have any special relief for the proposed producer companies. Upon notification from Parliament, it is quite possible that the producer companies would have similar treatment under the Income Tax Act as cooperatives or companies.

2.8.8 External Borrowing

With the recent notification of RBI regarding ECB by the NGOs (vide notification no RBI/2004-05/434 A.P.(DIR Series) Circular No. 40 dated 25 April 2005), it is quite likely that MFIs registered as producer companies would also have access to cheaper external funds for borrowing provided they meet the conditions laid down in the above notification.

2.8.9 Compatibility with Insurance Regulations

With its member-focused approach, producer companies are likely to provide a good opportunity for insurance companies to be tapped as channels for product distribution. It is quite likely that they will have similar status as cooperative societies and act as channels for the distribution of insurance products.

2.8.10 Advantages and Disadvantages for MFI Registration as Producer Companies

Advantages

- i Simple process of registration;
- ii Simple record-keeping and even simpler regulations;
- iii Low possibility of interference by the regulator; and
- iv Member-focused approach.

Disadvantages

- i As a member-owned organisation, bound to face the problems related to professional management and governance; also the profit-centric approach necessary for the long term sustainability of the microfinance programme may take a back seat;
- ii Tax exemption for surpluses not likely; and
- iii Commercial investors could shy away – as equity investment may not be possible in such organisations. Also debt investment would have its limitations, as such organisations by their design would have problems in mobilising equity.

2.9 CONCLUSIONS: INSTITUTIONAL ISSUES WITH MFIS IN INDIA

The above discussion clearly underlines the regulatory limitations of the legal framework for the microfinance sector in India. Though many innovative initiatives have been undertaken by Indian MFIs over the past five to seven years, their efficacy has been limited and their operations hamstrung by the absence of a supportive regulatory environment.

MFIs would like to provide financial services to low-income clients with the objectives of providing financial services to large numbers of low-income clients, and ensuring long-term sustainability, while operating within the boundaries of the legal framework.

As the discussion above suggests, the problems of these MFIs are manifold. While societies and trusts provide an initial breakthrough to start microfinance operations;

these structures are not appropriate for supporting the scaling-up of operations. MACS and producer companies may offer better options, but their lack of professional governance structures raises serious doubts in the minds of investors. Mobilising equity support for such institutions is also a problem. These factors hamper the scaling-up of operations as these entities would find it hard to mobilise the substantial volumes of funds required for expansion. Section 25 companies also suffer from such lacunae – though their problem is related mainly to equity mobilisation and thereby to the leverage capacity of such institutions. This brings the discussion to the two remaining options – NBFCs and cooperative banks. Following the problems with the cooperative banks over the last few years, RBI has been extremely reluctant to provide fresh licenses for such entities. NBFCs have a similar problem; RBI has been very reluctant to offer registration to new NBFCs for one reason or another, compounding the problem of raising the substantial capital requirement of Rs 2 crore.

The RBI has recently shown some willingness to provide registration to NBFCs established by MFIs. NBFCs established by Spandana in Guntur and SKS in Hyderabad have been registered during 2004-05. However, the problem of ownership structure is an issue for NGO-MFIs even if RBI starts being generous in providing registration to such entities. Societies are not allowed to promote companies since the Societies Act bars them from investing in equity. Some of the leading MFIs have found a 'noble' solution in the formation of Mutual Benefit Trusts (MBTs). Societies promote these MBTs through their clients and the MBTs, in turn, invest in the equity of NBFCs. The parent NGO-Societies could provide grant support to MBTs and this money may be used for equity investment in the NBFC. This appears to be a very safe solution despite MBTs not having the benefit of tax saving. However, some of these MBTs are using clients' savings also for investing in NBFCs as equity.

The ICICI Bank has tried to bring some innovation in order to find a solution to this problem. According to their arrangement, they enter into a partnership with an existing NGO-MFI or Section 25 company. While ICICI Bank provides the funds for client mobilisation and lending, these institutions, using their community mobilisation skills, form the groups and function as an agency for the bank. These loans to the clients or groups remain on the accounts of ICICI Bank and the MFIs provide the front-end services to the clients in return for a commission. This seems to be meeting both the ends – while the sanctity of the legal system prevails, clients also benefit from receiving credit services. However, since the ICICI Bank is currently the only bank applying this "partnership" model, this arrangement – which by-passes the capital adequacy norms that normally inhibit investors – heightens the dependence of the institution on a single entity and limits the ability of the institution to engage in product innovation since aspects like repayment conditions and interest rate to retail clients are specified by the agreement with the bank. A summary of the issues affecting the choice of institutional form by MFIs is contained in Table 2.9 below.

Table 2.9

Features of Legal Forms for Microfinance Institutions in India

Legal Entities	Registration	Start-up Capital	Regulatory Requirements	Investor Confidence		Deposit Mobilisation	Governance	Scaling up of Operations
				Equity	Debt			
Societies	Very easy and can be obtained within weeks	No minimum requirement	Cursory	Not possible- however grants could be provided	Low	Not allowed as per the guidelines of RBI though the central bank turns a blind eye if there are no problems[31].	Mostly informal	May be problematic; as the funds for upscaling would be hard to raise and ineffective management could hamper growth.
Trusts	Same as above	Same as above	Cursory	Same as above	Low	Not allowed in public charitable trusts - but can be mobilised in the case of private and mutually-aided trusts	Mostly informal	Same as above
Sec 25 Companies	Easy, but not as easy as those of trusts and societies; especially for an existing company to convert into a Section 25 company	None required	Exempted from most of the regulatory requirements of NBFCs	Not facilitative as Sec 25 companies are not allowed to declare dividends	High	Not allowed	Relatively better and more formal	Possible to scale up due to professional governance and high lender confidence. Problems may still come up due to lack of equity from commercial investors as the leveraging capacity of the organisation would be affected.

[31] For details on the topic refer to the discussions in Section 2.1 of the report.

Legal Entities	Registration	Start-up Capital	Regulatory Requirements	Investor Confidence		Deposit Mobilisation	Governance	Scaling up of Operations
				Equity	Debt			
NBFC	Difficult - may take up to a year as RBI has been very cautious in providing licenses	Rs 2 crore	Substantial – especially if the entity is allowed to mobilise deposits	High as the entry and exit (perceived) routes are easier	High	Allowed if it meets certain criteria - especially the need for an investment grade rating from a recognised agency[32]	Likely to be professional	It provides very sound background for scaling up of the operations as both the investor confidence and the management strengths are normally good with these entities.
Cooperative Societies (MACS)	Easy	Nominal	Nominal	Low; due to lack of a clear exit route	Moderate	Allowed from members	Doubtful - as it comes from the board members who are mostly beneficiaries. Raises issues of corporate governance as well.	Relatively easier. However, here again leverage can be a problem as there is no commercial equity investment
Cooperative Banks	Extremely difficult - RBI has not been entertaining any request for registration	Moderate – Rs1 lakh	Very high. Also subject to multiple regulations – by RBI and the state Registrar of Cooperatives	Low; due to lack of a clear exit route	High	Allowed	Same as above	Relatively easier. But better then MACS as the entry capital requirement itself is very high.
Producer Companies	Relatively easier	No minimum ceiling	Nominal	No external investors	High; as these entities would have more freedom in operations than cooperatives	Allowed from the members.	Same as above; as the basic character of such companies would be similar to that of cooperatives	Same as MACS.

[32] Refer to Section 2.5 for discussion on the topic.

3 STATUTORY REQUIREMENTS

This sub-section discusses the statutory requirements for different types of legal entities engaged in microfinance service delivery. It details the capitalisation issues and disclosure requirements that need to be satisfied by each type of entity.

3.1 CAPITALISATION, CAPITAL ADEQUACY AND EQUITY CAPITAL

As discussed in Section 2, MFIs registered as societies and trusts by their design lack a clear ownership structure, hence societies and trusts can only acquire funds of their own by way of donor grants and surpluses from operations. On the other hand, entities like cooperative societies, cooperative banks, companies registered under Section 25 of the Companies Act and NBFCs do have owners and hence also equity capital that becomes the financial under-pinning of their operations. Owned funds of the latter types of organisations, therefore, consist of the sum of shareholders' equity and surpluses from operations[33]. Such organisations rarely have donor grants but, to the extent that they receive such grants, these would also be included in the definition of owned funds. Investments in subsidiaries, companies in the same group and other NBFCs must be deducted from the above to the extent that such investments exceed 10 per cent of the NOF after reducing owned funds by any deferred revenue expenditure and other intangible assets. This constitutes the NOF of an NBFC. The value of minimum NOF required for different types of organisations to undertake financial operations is set out in Table 3.1.

Table 3.1

Net-Owned Funds required for Different Forms of MFIs

Legal Forms	Minimum Value of Net-Owned Funds
Cooperative Societies	A fixed per member contribution set by the bye-laws of the societies – for producer or financial cooperatives this is usually set at Rs100
Cooperative Banks	Rs1 lakh
Section 25 Companies (undertaking microfinance activities)	No minimum requirement
Non Banking Finance Companies	Rs 2 crore

Source: Discussion in Section 2 of this report

[33] Definition of the equity in terms of the Tier I and Tier II capital is discussed in the previous section of the report.

While the regulations on cooperative societies and Section 25 companies do not have any such stipulation, RBI as the regulator for NBFCs and cooperative banks has fixed strict capital adequacy norms for such institutions under Section 45 JA of the RBI Act. Thus, NBFCs are required to maintain a minimum capital adequacy ratio of 12 per cent, consisting of Tier I and Tier II capital where Tier II capital should not be more than 100 per cent of Tier I[34]. This minimum capital adequacy norm holds for cooperative banks as well. The enforcement of these capital adequacy norms is particularly much stronger in the case of NBFCs than it is for other entities like banks.

The Companies Act provides the regulatory platform for the equity capital holding of NBFCs and Section 25 companies. At the time of their registration as companies such entities need to declare their authorised and paid-up share capital. If these entities want to alter their authorised share capital, they need to seek the approval of the Registrar of Companies. The Companies Act, also specifies that companies must state their share-holding position in annual reports. Similarly, cooperatives must also declare their authorised share capital to the Registrar of Cooperative Societies and get approval for any alteration in the size of authorised share capital.

3.2 LEVERAGE AND INSTITUTIONAL DEBT

There are no obvious regulatory obstacles to any of the legal entities involved in microfinance – discussed in this report – leveraging their market position to obtain debt finance from domestic capital markets. Societies need to incorporate the power to borrow from commercial sources explicitly in their Memorandums of Association along with the specific inclusion of provision of microfinance services in their objects of association. Similarly trusts need to put these statements and powers explicitly in their trust deeds. Despite some change in this attitude, the concern of some banks (at the institutional level) in the case of loan requests from MFIs registered as societies or trusts is that since promoters have no personal financial stake in such institutions their commitment to the institution may not be as strong as necessary to ensure the prudential management of the banks' loan funds.

The legal framework for societies, trusts and cooperatives does not have any stipulations on leverage capacity. The ability to leverage the institution's capitalisation depends largely on the appetite of the lender for risk and also on the creditworthiness of the institution decided either by an independent or in-house appraiser of the lending institution. Given the quasi-charitable nature of microfinance, the financial institutions engaged in investing in MFIs do tend to have a somewhat higher appetite for risk in the MFI case than they do for normal commercial lending. However, since NBFCs and cooperative banks have capital adequacy norms decided by RBI, these effectively delimit the leverage standards for such institutions since the deployment of the borrowed funds would increase the volume of risk weighted assets of the MFI.

[34] For a discussion on the different prudential norms for the NBFCs, please refer to Section 2.4.3

3.3 EXTERNAL BORROWING

Until very recently the Government of India regulations did not allow ECB for financial sector institutions. The rationale provided by RBI for this were:

a. Excess liquidity in the existing banking system and the consequent need to encourage Indian institutions to diversify their channels for reducing that liquidity.

b. The inappropriateness of intermediation by Indian FIs between the end user and the prime lender. However, this argument only works if the end user is a large borrower and does not work for the end users of microfinance loans.

Yet, multilateral agencies (such as IFAD) were effectively lending to Indian MFIs at subsidised rates through their agreements with Indian development institutions (such as SIDBI). However in the Finance Bill for the year 2005-06, the microfinance sector has been allowed access to ECB. As per the notification issued by RBI vide RBI/2004-05/ 434 A.P. (DIR Series) Circular No. 40 dated April 25, 2005 the NGOs engaged in microfinance activities are allowed to access ECB provided they-

(i) should have a satisfactory borrowing relationship for at least three years with a scheduled commercial bank authorised to deal in foreign exchange and

(ii) would require a certificate of due diligence on ‘fit and proper’ status of the board/ committee of management of the borrowing entity from the designated AD.

This amount is currently capped under US$ 5 million for each MFI during a year. However the term used in the notification, NGO, has never been defined properly. The interpretation and understanding of the term might create some problem unless RBI comes out with a notification defining it clearly.

3.4 GRANTS AND SUBSIDISED ON-LENDING FUNDS

As discussed in the previous section of the report, all the entities taking up microfinance are allowed to receive grants and subsidised loans from domestic sources. However, in order to obtain grants from foreign sources, institutions must be registered with the Ministry of Home Affairs under the Foreign Contribution (Regulation) Act, 1976. Similarly, following the notification issued by RBI on the issue of ECB for NGOs, its possible for different types of entities to access subsidised funds for on-lending to their clients, provided they fulfill the necessary conditions, as laid down in the notification, to the extent of US$ 5 million each year.

The tax implications for different types of entities are different for grant incomes. Under Section 11 of the Income Tax Act, all grant funds meant for the corpus fund of religious and charitable societies are exempted from the taxation. Since microfinance is largely recognised as a charitable activity, the entire grant meant to support the corpus fund of the society is exempt from taxation. However, considering the debate over the charitable nature of microfinance, this tax exemption also becomes debatable. Since private trusts taking up microfinance activities are also subjected to the same provisions of the IT Act, their grant income may also be exempted from the taxation. This provision also applies to Section 25 companies but not to cooperative societies, cooperative banks and NBFCs. As for-profit entities the latter types of institutions must treat grants received as income and pay tax on this income at normal rates. In the case of private trusts where taxation is applicable, the value of the subsidised lending or the in-kind donation is taken as income for the calculation of tax. The same holds for the other types of entities too. However the position of taxation on the subsidised lending is not clear; it definitely holds for the in-kind donations to all types of entities.

3.5 FOREIGN DIRECT INVESTMENT

The context of foreign direct investment is applicable only to Section 25 companies and NBFCs. Section 25 companies are allowed to obtain FDI as equity. However, on account of their not-for-profit constitution that prohibits the distribution of dividends, they are not an attractive option for such investment. NBFCs can obtain foreign capital in the form of equity subject to approval by the Foreign Investment Promotion Board (FIPB). The minimum capital requirement for such FDI is US$ 0.5 million when the external equity is limited to less than 51 per cent of the total equity. Table 2 sets out the minimum FDI requirement for different levels of foreign equity holding in the Indian financial sector.

Table 3.2

FDI in the Financial Sector

Option	Minimum Foreign Capital, US$ Million
FDI up to 51%	0.5
FDI more than 51% but less than 75%	5.0
FDI more than 75%	50.0

Source: Taxmann's Statutory Guide for Non-Banking Financial Companies

3.6 CAPITAL MARKETS

Owing to their structure and the charitable nature of their objectives, societies and trusts are not an option for the capital market. Though there is nothing in the legislation that prohibits them from accessing capital markets, the lack of an ownership structure is the major impediment for capital markets to take an interest in financing such institutions.

Cooperative societies and cooperative banks, with their distinctly for-profit constitution can, theoretically, obtain funds from capital markets. However, the dismal fiduciary performance of UCBs in recent years is a major dampener on any attempt such institutions may make to access these markets. NBFCs can also access capital markets subject to their adhering to the prudential and reporting norms of RBI. Both types of institutions need to report their capital market transactions periodically to the central bank on prescribed formats. In order to access equity funds from capital markets, NBFCs need to be listed with a stock exchange. They would need to offer an issue. Primarily, issues can be classified as Public, Rights or Preferential (also known as private placements).[35] While public and rights issues involve a detailed procedure, private placements or preferential issues are relatively simpler. Public issues can be further classified into Initial Public Offerings (IPOs) and further public offerings.[36] In a public offering, the issuer makes an offer for new investors to enter its shareholding family. The issuer company makes detailed disclosures as per DIP (Disclosure and Investor Protection) guidelines[37] in its offer document and offers it for subscription. The Securities and Exchange Board of India (SEBI) – which regulates the functioning of capital markets – has laid down eligibility norms for entities accessing the primary market through public issues. There is no eligibility norm for a listed company making a rights issue as it is an offer made to the existing shareholders who are expected to know their company. The main entry norms for companies making a public issue (IPO or FPO) are summarised as under:

Entry Norm I: The company shall meet the following requirements:

a. Net Tangible Assets of at least Rs 3 crore for three full years;
b. Distributable profits in at least three years;
c. Net worth of at least Rs 1 crore in three years;
d. If change in name, at least 50 per cent revenue for the preceding one year should be from the new activity; and
e. The issue size does not exceed five times the pre- issue net worth.

To provide sufficient flexibility and also to ensure that genuine companies do not suffer on account of rigidity of the parameters, SEBI has provided two other alternative routes to a company not satisfying any of the above conditions, for accessing the primary market.

[35] Rights Issue (RI) is when a listed company which proposes to issue fresh securities to its existing shareholders as on a record date. The rights are normally offered in a particular ratio to the number of securities held prior to the issue. This route is best suited for companies who would like to raise capital without diluting stake of its existing shareholders unless they do not intend to subscribe to their entitlements. A preferential issue is an issue of shares or of convertible securities by listed companies to a select group of persons under Section 81 of the Companies Act, 1956 which is neither a rights issue nor a public issue. This is a faster way for a company to raise equity capital.

[36] Initial Public Offering (IPO) is when an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public. This paves the way for listing and trading of the issuer's securities. A follow-on public offering (FPO) is when an already listed company makes either a fresh issue of securities to the public or an offer for sale to the public, through an offer document. An offer for sale in such scenario is allowed only if it is made to satisfy listing or continuous listing obligations

[37] The primary issuances are governed by SEBI in terms of SEBI (Disclosures and Investor protection) guidelines. SEBI framed its DIP guidelines in 1992. Many amendments have been carried out in the same in line with the market dynamics and requirements. In 2000, SEBI issued "Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000" which is compilation of all circulars organised in chapter forms. These guidelines and amendments thereon are issued by SEBI India under Section 11 of the Securities and Exchange Board of India Act, 1992. SEBI (Disclosure and Investor Protection) guidelines 2000 are in short called DIP guidelines. It provides a comprehensive framework for issuances buy the companies.

Entry Norm II (EN II):

a. Issue shall be through the book-building route, with at least 50 per cent to be allotted to the Qualified Institutional Buyers (QIBs), which is mandatory.
b. The minimum post-issue face value capital shall be Rs10 crore or there shall be a compulsory market-making for at least two years.

Entry Norm III (EN III):

a. The "project" is appraised and participated in to the extent of 15 per cent by FIs/Scheduled Commercial Banks of which at least 10 per cent comes from the appraiser(s).
b. The minimum post-issue face value capital shall be Rs 10 crore or there shall be a compulsory market making for at least two years.
c. In addition to satisfying the aforesaid eligibility norms, the company shall also satisfy the criteria of having at least 1,000 prospective allottees in its issue.

Any company making a public issue or a listed company making a rights issue of value of more than Rs 50 lakh is required to file a draft offer document with SEBI for its observations. The company can proceed further on the issue only after getting observations from SEBI. The validity period of SEBI's observation letter is three months only, i.e. the company has to open its issue within a three-month period. *(For further details on this subject please refer to the latest SEBI manual).*

3.7 DISCLOSURES

All the legal entities involved in the business of microfinance are subject to some form of disclosure:

a. Societies and trusts are subject to the annual disclosure of accounts to their registrars;
b. Cooperative societies report to the Registrar of Cooperatives on prescribed formats;
c. Cooperative Banks, like NBFCs, also need to make several disclosures on such areas as the Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR), details of public deposits, asset-liability management, income recognition and asset classification to RBI; and
d. For NBFCs – especially those accepting public deposits – RBI's regulations on disclosure are equally strict for NBFCs. These companies must make periodic disclosures on parameters like SLR, public deposits and access to capital markets (if the deposit is more than Rs50 crore), asset-liability management, asset classification and income recognition. The norms on disclosure for NBFCs have been discussed at great length in the preceding section. Detailed listings of disclosures on NBFCs are covered in Sections 2.4.2, 2.4.3 (2.4.3.1, 2.4.3.2, 2.4.3.3, 2.4.3.4) and 2.4.4 (in the case of deposits).

Table 3.3 summarises the statutory requirements applicable to different types of institutions in the financial sector in India.

Table 3.3

Statutory Requirements for Various Legal Forms

Institutional Variable	Societies	Trusts	Cooperative Societies	Cooperative Banks	Section 25 Companies	Non-Banking Finance Companies
Capitalisation	None	None	No specified minimum	Rs1 lakh	No specified minimum	Rs 2 crore
Capital Adequacy	None	None	None	10% (including both Tier I and Tier II capital)	None	12% (including both Tier I and Tier II capital). Tier II capital not > Tier I capital)
Equity Capital	None	None	Authorised capital to be declared at the time of registration with the Registrar of Coopera-tive Societies; change in authorised capital to be approved by Registrar.	Authorised share capital to be declared to RBI and any change in it to be ratified by RBI.	Authorised capital to be declared at the time of registration with the Registrar of Companies; change in authorised capital to take effect only upon the approval of the Registrar.	Authorised capital to be declared at the time of registration with the Registrar of Companies; any change in authorised capital to take effect only upon approval of the Registrar.
Leverage and Institutional Debt	No regulatory restriction; Memorandum of Association must permit commercial borrowing.	No restriction; trust deed must permit commercial borrowing.	Societies allowed to borrow from institutional sources and there is no restriction on the leveraging.	No restriction on com-mercial borrowing or le-veraging but limited by capital adequacy norms.	Borrowing allowed; but no restriction on the leveraging.	No restriction on the institutional borrowing and also no restriction on leveraging though capital adequacy norms impose a limitation.
External Borrowings	Allowed if meets certain criteria.	Allowed, if meets some criteria.	Allowed, if meets some criteria.	Allowed, if meets some criteria.	Allowed, if meets some criteria.	Not clear as yet. Might be allowed once clarity emerges.

Institutional Variable	Societies	Trusts	Cooperative Societies	Cooperative Banks	Section 25 Companies	Non-Banking Finance Companies
Grants and Subsidised Loans	Allowed and grants exempt from tax if used for charitable purposes.	Allowed and exempt from tax if used for charitable purposes.	Allowed but not exempt from tax.	Allowed but not exempt from tax.	Allowed and exempt from tax.	Allowed but not exempt from tax.
Foreign Direct Investment	Not Applicable	Not Applicable	Not allowed	Not allowed	Allowed but not-for-profit nature of institution makes it incompatible with investor interests.	Allowed with some limitations. If foreign ownership <51%, then minimum of US$0.5 million. If foreign ownership > 51% but <75%, the minimum investment is US$5 million. Foreign ownership >75% = minimum requirement of US$50 million.
Capital Markets	No Access	No access	Allowed (both in the form of equity and debt)	Allowed (both in the form of equity and debt)	No restriction, but the not-for-profit nature makes it incompatible with market requirements.	Allowed with strict reporting requirements.
Disclosure	To the Registrar of Societies on an annual basis in the form of annual accounts statement.	If registered, to the Registrar on an annual basis in the form of annual accounts statement.	Annual reporting to the Registrar of Coopera-tives and compliance with cooperative law.	Annual reporting to the Registrar of Cooperatives and compliance with cooperative law.	Compliance with provisions of company law and reporting to the Registrar of Companies on annual basis - essentially accounts, shareholding pattern and board membership.	Reporting to Registrar of Companies and RBI as per their requirements. Reporting to Registrar of Companies largely annual, but reporting to RBI has varying periodicity for different requirements. Disclosures on maintenance of statutory liquidity, details of public deposits, information on opening/ closing of branch offices for collection of deposits, details of NOF, asset-liability management, income recognition and asset classification.

4 Techno-managerial Capacity Requirements with respect to the Legal Framework

This section discusses the governance and management related capabilities of Indian MFIs and relates these to the needs imposed by the regulatory environment on different legal forms. It also covers trends in the governance and management practices of MFIs and the resulting implications for transformation between legal forms

While the legal status of the MFI provides credibility in terms of the legal environment, it is its governance and management capability that provides the critical capacity to upscale and achieve sustainability in the long run. While conformity with the prevailing legal structure is, of course, a minimum condition – its robust governance and the managerial capability is essential for its survival in the long run.

In considering the operations of MFIs, the critical functions are

- governance and institutional linkages;
- human resource management;
- MIS and its use for decision-making;
- accounts and financial management; and
- internal audit and control systems.

Governance provides the strategic focus for the organisation. It also decides on the overall management setup of the organisation and leads the operations. While the human resource management function provides motivation and guidance to the most important of the resource of the organisation, MIS provides vital inputs on the status of operations and helps in taking appropriate decisions for smooth and even better operations. Accounts and financial management systems are important for compliance with standards and practices that ensure an accurate representation of the financial position of the organisation for transparency and regulatory purposes and to achieve an optimisation in the use of the financial resources of the organisation. This section discusses the techno-managerial capabilities of MFIs in India in relation to each of these functions. M-CRIL's database[38] provides the numerical foundation necessary to substantiate the findings of the authors.

4.1 GOVERNANCE AND INSTITUTIONAL LINKAGES

A governance system can be defined as "*what manages the relationship of an institution with its stakeholders or, more broadly, its relationship to society*"[39]. The governance system

[38] M-CRIL is a rating company specialising in the risk assessment of MFIS in South and South-East Asia. It has rated 148 MFIs in different parts (in 13 countries) of Asia till December 2004. A majority of these are located in India. It maintains a database of MFIs rated by it and comes out with a sectoral report periodically. The database of performance of these MFIs gives a fair indication of trends in the sector.

[39] Adapted from an article that appeared in the Financial Times, 1997

determines how institutions are directed and controlled. It specifies the distribution of rights and responsibilities among different participants in the institution, such as, the governing board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which institutional objectives are set and the means of attaining those objectives and monitoring performance.

The governing board is the strategic apex of an organisation and is, therefore, the primary determinant of its governance system. The board composition, the framework it sets for itself and the way it functions form the basis of the governance system. The board also has the key function of ensuring conformity and compliances to legal requirement, ensuring management accountability, setting policy and strategic direction and regular assessment of their own performance. The board also has the additional, but a very important role of ensuring the transparency and accountability of its actions.

Institutional linkages constitute another important factor that affects how an organisation is governed and managed. Institutional linkages are the unique systems and arrangements that help an organisation operate, evolve and grow in an efficient manner. These range from the formal subsidiary-parent relationships and contractual agreements for the provision of certain services, to an informal understanding on cooperation between several entities. In cases where the institutional linkages are well defined and developed, they have a direct bearing on how the organisation is governed and how it functions.

4.1.1 Sector Profile[40]

Institutional linkages

In the context of the Indian microfinance sector, many MFIs have evolved either as offshoots of older development organisations or are the result of projects being formalised into an organisation. A large number of such institutions have been started by people with prior experience in the development sector. There are still others, though fewer, who have emerged to deal exclusively with the credit needs of a particular area/community. This varied evolution has led to the many formal/informal institutional linkages that MFIs have with their parent organisations.

This link between parent NGOs and MFIs is also reflected in the methodology and use of resources. A large number of MFIs use the group model for providing financial services and, often, these financial services are extended to groups promoted by the parent for some other development activity. The MFIs also use the *parents' resources* to promote financial services, identify areas with potential for expansion and, sometimes, even cover operating costs. Given the human, financial and knowledge resource

[40] Adapted from M-CRIL, 2003. "Improving Microfinance Practice"

constraints as well as the nature of work, developmental organisations in India have partly developed formal/informal *networks* amongst themselves for sharing resources and participating in joint dialogue with the formal sector. The linkages that have developed are often used by the MFIs for leveraging resources. The older NGOs (or other parent organisations) have also been able to build *relationships with the formal sector* during the course of their work. These relationships are often inherited by the offshoot MFIs and used for their benefit. From this phenomenon, some interesting experiments have developed. The Indian Association of Savings and Credit (IASC) – a partnership between an NGO and a housing finance company – is one prominent example.

The Role of the Board

In Indian MFIs, typically, the members of the board comprise the promoters, a few local academics or social workers and some representation from the executive in the form of the chief executive officer (CEO). Some organisations also have member representatives on the board.

Given that many MFIs have evolved from social development programmes, more often than not, the *composition* tends to be skewed towards people with a social development outlook. While such a representation is important, the composition of the board is often imbalanced with limited financial and technical skills available amongst board members.

Traditionally, the MFI board's expected role has been to lay down the framework for operations and meet regularly to review performance and decide on key issues. However, the fulfilment of this objective has, so far, been limited. Usually, the operations run on the basis of a loosely defined framework that is firmed up as and when specific issues emerge.

On policy issues the boards of many organisations are known to take a 'developmental' view that is almost exclusively focused on the short-term interests of their clients while being against the interests of the organisation itself. This results in the creation of institutions that do not perform efficiently, and, in the medium to long run, tend to stagnate or close down. Therefore, from a broader perspective, such inputs by MFI boards do not serve either client or organisational interests in the long term as they prevent the creation of MFIs that can balance client and institutional objectives while increasing outreach.

Another factor that contributes to the lack of sufficient inputs from the board arises from the low level of interest in MFI operations that many board members display. In the overall operations, except for the CEO and, in some cases, the executive secretary/ chairman, the other members often have very limited interest and involvement.

However, this situation in governance is evolving and a number of MFIs are now putting in place governing boards that have a balance of social development and financial management skills. This trend has arisen out of increasing pressure to make operations sustainable, convert to more commercial and legally appropriate forms for undertaking financial service provision (such as NBFCs that are regulated by RBI) and a realisation that the complexities of managing operations and finances are facilitated greatly by a board with the requisite technical and financial skills. As a result, boards are now becoming increasingly active and laying down guidelines with respect to managerial functions. Overall, there is a gradual shift in the focus of board members towards sustainable development rather than just altruistic lending. The following sections illustrate the ways in which this shift in the governance structure as well as institutional linkages is occurring.

4.1.2 Best Practices and Emerging Trends

The board composition, the framework it draws up for itself and the way it functions forms the basis of the governance system. In addition, institutional linkages influence governance issues and vary vastly, based on the type of organisation. The following are the trends on governance and institutional linkages that have been observed recently.

Table 4.1

Best Practices on Institutional Linkages and Board Performance

Institutional linkages	
Member-based organisations	• Clear procedure to exercise owner control • Specific roles assigned to that tier in the hierarchy best suited to the role; these distinct roles complement each other to create operational convergence • Operations managed by professionals who are appointed and supervised by an elected board • Integrated systems wherein the MFI leverages the relationships that its different arms have with the borrowers
Corporate and social sector partnership	• Benefits from both parents – local development knowledge from the social partner and professional managerial expertise from the commercial partner • Leveraging the goodwill of both partners to form local alliances and mobilise funds
New generation financial institution	• The holding company, being a larger entity, is able to mobilise external sources of finance

	• Leveraging a host of institutional relationships that the holding company and other subsidiaries have built up with the external agencies • Utilising the business synergies with the various sister companies. For example, Samruddhi uses the technical skills of IGS to train its micro-entrepreneur clients.
Role of the board	
	• Balanced board composition with representation from corporate and development management experts • Ensuring the stake and role of managers in organisational governance and development, by employing innovative measures such as sweat equity • Clear functional responsibility centres within the board – like Audit and a Finance Committee constituted by board members • Systematic mechanism to provide the board with feedback from a broad range of stakeholders • Ensuring transparency in the functioning of the organisation and accountability for the actions taken by it

Source: M-CRIL, 2003. “Improving Microfinance Practice”

The overall trend within MFIs in India is to move from an altruistic approach to a professional and sustainability-oriented approach. Some of the emerging ways through which MFIs are trying to achieve this are:

a. *More active boards*: The governing boards of MFIs are becoming increasingly active not only in shaping institutional direction but also in ensuring that their directives are implemented through the board members’ direct oversight of day-to-day operations.

b. *Composition of the board*: MFIs are now consciously trying to induct finance professionals and eminent practitioners as board members. Overall, this has the effect of injecting a professional culture into the organisation and the microfinance sector as a whole. It also enhances the leveraging ability of the organisation in relation to its external environment.

c. *Separate organisations/divisions for undertaking different tasks*: More and more multi-service organisations are moving towards the separation of microfinance divisions or even separate organisations for undertaking non-core activities. Thus, what has traditionally been called the "credit and savings programme" is now becoming an MFI in its own right or an independent microfinance profit centre.

d. *Building external arrangements to leverage local knowledge and operating systems for generating revenue streams*: A few MFIs are leveraging their local knowledge and networks to develop arrangements with large financial service providers for selling specialised products and services. Selling insurance products is a very good example of this trend. Other MFIs are trying to become agents of commercial banks, for onlending. Under this arrangement, the bank appoints the MFI as its agent who in turn does the lending for the bank and earns a commission on it. These arrangements are covered in the following sections.

4.2 HUMAN RESOURCE MANAGEMENT

Human resource management is "*a process consisting of the acquisition, development, motivation and maintenance of human resources.*[41]"

People enable an organisation to operate. In microfinance, due to the absence of the mechanisation that is associated with production organisations, people take on an especially significant role since they undertake all activities that generate revenue. This makes managing human resources, an important part of an organisation's operations.

4.2.1 Current Status of MFIs on Human Resource Management

The performance of Indian MFIs on human resource quality and management – emerging from M-CRIL's rating assessments – is summarised in Table 4.1. The table shows that the quality of human resources in MFIs is average, leaving room for a lot for the improvement. A disaggregation of this performance by legal form shows that MFIs with more professional legal forms – companies and, to some extent, cooperatives – are more likely to perform better on this. Compared to just 15 per cent of MFIs registered as societies and trusts that have excellent or good human resource quality and management, 46 per cent of companies and 35 per cent of cooperatives have been judged by M-CRIL to be in these categories.

Table 4.2

Quality of Human Resource and Management

Performance[42]	Trusts/ Societies	Cooperative/ MACTS	NBFCs/ Sec 25 Co.	Total
Excellent	0	0	2	2
Good	15	6	4	25
Average	62	11	5	78
Poor	20	0	2	22
Total	97	17	13	127[43]

Source: M-CRIL's Database

It is apparent that, by and large, MFIs registered as societies and trusts have very moderate manpower quality and management systems. On the other hand, while a number of MFIs registered as NBFCs and regulated companies have excellent performance on this parameter, there are an equal number with poor quality and management systems. It is worth mentioning here that almost all NBFCs and Section 25 companies were initially promoted by societies/trusts and have transformed into more professional entities on account of their managerial strength in order to leverage the credibility that investors and lenders attach to companies, in particular. Therefore, it is perhaps systemic that companies are more likely to be organisations with strong systems while those that lack the strength to transform remain as societies and trusts. The discussion in the following section tries to find reasons for this and the emerging trend in the sector.

4.2.2 Best Practices and Emerging Trends in Human Resource Management[44]

Given that many MFIs in India have evolved from multi-service NGOs with a welfare orientation, they tend to focus on staff that have a development background and are willing to work in the 'tough', 'grass-roots' conditions that they operate in. While this is certainly an important aspect, unfortunately, there is excessive emphasis on it. Most NGO-sponsored MFIs do not rely on recruitment as a tool for getting qualified senior staff. Instead, they often redeploy senior staff from their other development activities to microfinance. Though this is occasionally successful, the redeployment often leads to microfinance being conducted as merely another development assistance programme rather than a potentially sustainable activity. As a result of these inappropriate recruitment practices, management systems tend to be underdeveloped and inefficiencies creep in.

[42] The performances of the MFIs are classified into these four categories based on the observation made by the rating team in the course of their visit to the organisation. While attempts have been made to make the observations as objective as possible, the variation in the performance level within the same category cannot be ruled out.
[43] Total number of Indian MFIs rated by M-CRIL by 31 December 2004
[44] Adapted from M-CRIL, 2003. "Improving Microfinance Practice"

This is particularly relevant at middle and senior management levels. The idealistic approach of MFIs that are societies/trusts often prevents them from using monetary incentives as a tool for motivation. Some of the better performing MFIs have overcome these blocks.

Training is mainly in-service, though there is an increasing trend towards sending staff for training programmes – whether domestic or international – sponsored by development assistance organisations. This trend of increasing professionalisation of human resource practices is visible on all the four components of human resource management – acquisition, development, motivation and maintenance. The best practices on all of these components are important for each type of organization, irrespective of their legal form and are presented in Table 4.2.

Table 4.3

Best Practices in Human Resource Management for Indian MFIs

Component	Characteristics
Acquisition	• Recruitment methods matched to job level and skill • Rigorous selection to minimise costs of replacement • Multiple levels of elimination ensures that only the candidates seriously planning to have a career in microfinance would remain in contention • Use of tests that assess job-related skills
Acquisition	• Performance simulation tests through field visits • Background investigations – useful as the operations involve handling large amounts of cash • Documented and systematic process of recruitment • Formal orientation period allows new employees to move into their jobs gradually
Development	• Formal training needs assessment process • On the job training · Refresher courses to reinforce learned skills • Individual career development through self-assessment • Support for continuing education ensures that needed talent is available within the organisation
Motivation	• Established performance standards for all staff – thus, the field staff are appraised based on the number of groups they form and financial targets achieved, while the branch managers are appraised on the achievement of the branch target • The actual performance is measured through regular reports that are part of the MIS, ensuring objectivity·

	Appraisal linked to a number of objective and subjective parameters ensures all round staff productivity ● Performance-based incentives for staff – a number of MFIs have a part fixed and part variable incentive system, the variable part of which is linked to the key performance standards (refer first point) which provide staff with an incentive to perform well
Maintenance	● Sponsored training programmes – investment in sponsored skill enhancement is viewed as an incentive and is being increasingly used as a retention tool · Fast track promotions for high performers – a number of MFIs promote staff who perform well quite fast. This applies especially to field staff and acts as a motivation for them to stay· Earn more as you perform better – performance-linked incentives without strict limits makes it possible for good performers to earn significant additions to their remuneration, which acts as an incentive to stay

Source: M-CRIL, 2003. "Improving Microfinance Practice"

MFIs need to recognise the significance of a skilled and committed human resource and therefore try to develop systems that attract and support employees. Some emerging trends among more professional MFIs are:

a. *Separation of Human Resource Management as a key function:* With the increasing importance of this function, some MFIs are separating this function from general administration and deputing qualified personnel and adequate resources to ensure that human resource issues are properly addressed.

b. *Recruiting professionals:* Moving away from a pure social development perspective, MFIs have started recruiting suitably skilled professionals as managers whose skills are required for any well-run financial intermediation activity. Sourcing of staff is undertaken from institutes that offer courses in rural management. Though this means an increase in personnel recruitment and retention costs, efficient and well-managed operations help earn more income. Additionally, since a number of financial lending institutions have started looking at the quality of an organisation's staff base before investing in them, this also helps in raising resources for the organisation's activities.

c. *Focus on induction and orientation:* The selection and induction of a new employee is becoming a well-laid out systematic process that aims to develop basic knowledge of microfinance and the skills needed for operations.

d. *Training and Grooming field staff*: MFIs are now including training in their business plans as an investment in building skills. This includes external training.

Earlier, training was only undertaken at the donor's initiative. However, more and more MFIs are now leveraging the knowledge of local resources.

e. *Incentive-based salaries:* An increasing number of MFIs are adopting composite salary structures with fixed and variable components. The variable component is based on the performance of staff on factors that are critical for the organisation's operational success and the achievement of its objectives.

4.2.3 Requirements with Respect to Various Legal Forms

Thus, in order to acquire significant size and upscale MFI operations, the techno-managerial requirements are identical for all types of legal form. At the same time, there is not much need to comply with legal requirements with respect to human resource management for different legal forms – but for the requirement of hiring a company secretary in the case of an NBFC and Section 25 company. In case the company holds a paid-up share capital of Rs 200 lakh or more, it needs to hire a company secretary full time. If the company has a paid-up capital in the excess of Rs 10 lakh but less than Rs 200 lakh, then it needs to get itself audited by a company secretary annually to conform to the regulatory compliances. However, companies with paid-up capital of less than Rs 10 lakh do not need to comply with this requirement. The other legal forms like societies, trusts, cooperatives and cooperative banks do not have any such specific requirement. Other requirements such as interaction with the labour regulation and provident fund systems are common to all legal forms.

4.3 MANAGEMENT INFORMATION SYSTEM

A management information system captures data, processes it and provides relevant information for control, analysis and decision-making at the operational and strategic level in a cost-efficient and timely manner.

From the definition above it is clear that, given their critical link with decision-making, MIS is required in every type of organisation. However, an MIS has special relevance for MFIs, given that their operations involve very <u>large numbers of small financial transactions</u> with clients at short intervals. These transactions have to be monitored constantly to assess the health of the organisation and decide on future actions. Thus, operational and strategic decision-making in an MFI relies heavily on appropriate and timely information being gathered through effective systems.

Generally, good MIS should incorporate the following characteristics;

a. *User friendliness* for data entry and reporting: MIS are mostly used by semi-skilled personnel at the branches and need to provide a good user interface to minimise error.
b. *Timely, accurate and reliable information:* The microfinance business is fast moving involving numerous transactions and decision-makers who need reliable information on time to facilitate control and decision-making.

c. *Design and output flexibility* to suit the organisation's changing needs: Given the sector's nascence and rapid growth, most MFIs are growing at a brisk pace and information needs are constantly changing. This requires systems that can be modified and upgraded easily at a reasonable cost.
d. *Links to ensure data flow* within an organisation: To improve cost efficiency and human resource productivity, it is important to link up the MIS with other management systems like accounting.
e. *Secure and stable architecture:* The large number of transactions and the resulting storage and processing requirements make stability and security an area of vital importance for MFIs.
f. *Cost-effectiveness:* Considering the delicate financial health and low margins earned by most MFIs, it is necessary that the system be highly cost-efficient.

4.3.1 Current Status of MIS employed by MFIs

In practice the information on MIS – from M-CRIL's database presented in Table 4.3 – shows that not many MFIs have suitable MIS of reasonable quality and many still need substantial improvement to enable the MFI to scale up operations efficiently. The disaggregation by legal form shows that while companies are more likely to have a good MIS, other types of MFI are unlikely to do so. Clearly there are many organisations at the bottom of the heap, irrespective of their legal form.

Table 4.4

MIS quality of Indian MFIs

Performance	Trusts/ Societies	Cooperative/ MACTS	NBFCs/ Sec 25 Co.	Total
Excellent	0	0	3	3
Good	19	2	4	25
Average	23	5	4	32
Poor	55	10	2	67
Total	97	17	13	127

Source: M-CRIL Database

4.3.2 Best Practices and Emerging Trends in MIS

As discussed earlier, it is apparent that the importance of MIS must increase with the size of its operation – as does its complexity. This also means a shift from the manual system of MIS to computerised systems to the extent possible. Table 4.4 on the key aspects of a good MIS – both manual and computerised – shows that information systems provide the foundation for building control and incentive systems as well as for facilitating daily decision-making.

Table 4.4

Key Aspects of a good MIS

Characteristic	Manual	Computerised
User-friendliness	• Easy to use forms not requiring high data entry skills	• Graphic user interface-enabled software with user-friendly data entry screens and menus for generating outputs. • The interface reduces the task of entering the loan numbers repeatedly
Accuracy and Reliability	• Care in avoiding duplication in formats reduces manual errors· A large number of checks by branch managers and head office staff	• Integration of accounts and portfolio modules reduces manual transfer errors. • Semi-automated transfer of data from the portfolio to the accounts module allows corrections.· Fixed input cells with validation conditions prevent erroneous entries.
Flexibility and Expandability		• Purchasing of source code enables further modifications. • Determined by operational load; use of software that has an adequate processing capacity to enable quick retrieval. • Flexibility to generate a wide variety of key reports on various critical parameters easily and in a time-bound and cost-efficient manner.
Data flow	• Decentralised recording, consolidation and cross-checking of data at appropriate operational levels, in a timely and efficient manner. • Logically linked and sequenced recording formats	• Decentralised recording and consolidation at the branch level. Daily transaction entries are made at the branch level and updated at the head office on a weekly basis. • Overall consolidation at head office through back-up storage devices reducing the physical transfer of reports. • Reduced redundancy in input screens

Characteristic	Manual	Computerised
Architecture (maintenance, security & technical design)	• Access to books of accounts restricted to enhance security	• Use of tested software with a stable architecture and easy to maintain with the organisation's in-house IT capability. • Data security maintained through properly defined user rights. • Access to source code is restricted to the administrator and developer.· Software specifications in line with the volume of transactions preventing a system crash due to overload. • Back-up data of the branches stored at the head office. This ensures security while also being cost-effective. • Use of temporary tables for daily transactions which does not affect the master tables without confirmation by the authorised person.
Reporting	• Standardised report format from each branch allowing quick consolidation at the Head Office. • Frequency of reporting concurrent with operational decision-making. • Reports capture all the relevant information at the field level.	• Standardised set of comprehensive reports which are disseminated to various levels according to predefined dates and frequency.

Characteristic	Manual	Computerised
Process	• Ongoing analysis of information needs and objectives. · Continuous upgrades in the recording formats and reports to meet the changing needs.	• Critical analysis of existing information system, involving all stakeholders, to identify shortcomings and assess needs. • Establishment of an exclusive team to interface between the vendor and the operations team. • Formalised contract with vendor for software development and post-purchase maintenance. • Comprehensive audit and documentation of the new system to verify definitions and outputs. • Networking with other institutions using the same software for upgrading and debugging. • Adequate (over a few operating cycles) piloting and testing of software before implementation.

Source: M-CRIL, 2003. "Improving Microfinance Practice"

As organisations in the microfinance sector in India grow, they feel the need to manage their information better as the volume of data handled by each MFI expands. This has led to a number of innovations in the information management sub-systems of collection, transfer, processing, storage and reporting. Amongst all of these sub-systems, the most critical and expensive in microfinance is collection and this is where most innovations are being attempted. This is being targeted at two levels

a. *Streamlining of business processes*: A number of organisations that had earlier restricted themselves to established models such as Grameen or SHG are now adopting a mix of strategies, including individual lending, that reduce the cost of transaction management. Since gathering information imposes a significant cost, considerable attention is being focused on it.
b. *Automation*: New methods of managing collection are being experimented with. These range from low-end hand-held smart card readers with data entry screens to more sophisticated small computing systems that perform basic consolidation and processing functions.

Overall, as the sector matures and systems are tested more rigorously, a more universal architecture of appropriate information systems for microfinance is likely to emerge.

4.3.3 Requirements with Respect to Various Legal Forms

MIS as a function has a different level of importance than it has for regulatory compliance. The stipulations from RBI require NBFCs to file their financial reports on a periodic basis. All NBFCs also need to file their accounts and income returns with the Income Tax authorities. Similarly Section 25 companies need to file their annual accounts with the Registrar of Companies. While the reporting of cooperatives is limited to the Registrar of Cooperatives, cooperative banks are subjected to multiple regulatory compliances with both the cooperative department and NABARD – as the RBI-designated supervisor. While the prime purpose of the MIS is to facilitate management decision-making through the processing/analysis of available information, incorporating the elements of regulatory compliance is essential to enhance its effectiveness. As the discussion above indicates, MFI performance in this area is largely below the necessary standard that will enable high growth and adequate compliance with legal requirements.

4.4 FINANCIAL MANAGEMENT AND ACCOUNTING POLICIES

"Financial management is concerned with the acquisition, financing and management of assets with some overall goal in mind.[45]"

From its definition it is evident that financial management, with its three inter-related sub-functions, is a critical management issue for all MFIs. Accounting refers to the recording, classification and summarising of economic events resulting in the consolidation of information and presentation of financial statements that can then be used for decision-making purposes. Accounting is guided by certain universal principles though accounting practices are open to interpretation even while seemingly adhering to these principles. The sound use of policies and disclosure of financial information is the key to all financial management decisions. Poor accounting practices lead to inaccurate financial statements and, in turn, financial management decisions become sub-optimal.

Therefore, the prime functional area of financial management and accounting practices are investment, financing, asset management and accounting policies.

4.4.1 Current Status of MFIs on Financial Management and Accounting Practices

As discussed in earlier sections, the information from M-CRIL's database in Table 4.5 again shows a somewhat better performance on financial management and accounting systems for Indian MFIs registered as companies though there are still some MFI companies with relatively poor quality of such management as well.

[45] Horne, VHC and Wachowicz, JM, 2000. Fundamentals of Financial Management. Prentice-Hall of India

Table 4.6

Quality of Financial Management and Accounts of Indian MFIs

Performance	Trusts/ Societies	Cooperative/ MACTS	NBFCs/ Sec 25 Co.	Total
Excellent	0	0	2	2
Good3	0	4	7	
Average	30	8	5	43
Poor64	9	2	75	
Total97	17	13	127	

Source: M-CRIL Database

It is clear that the MFIs registered as societies and trusts due to their non-profit orientation have a long way to go in improving their financial management and accounting practices. While the legal form does not guarantee a better performance on any parameter, it is apparent, as discussed earlier, that it is some of the better-managed MFIs that transform and register as NBFCs and Section 25 companies – though this is not invariably so.

4.4.2 Best Practices and Emerging Trends in Financial Management and Accounting

Good practice in financial management and accounting provides financial benefits, long-term direction and stability to the operations of MFIs. Clear accounting policies contribute to disclosure and transparency in terms of reporting financial performance and providing an accurate reflection of the financial position of the MFI. The key aspects of good practice in financial management and accounting are set out in Table 4.6.

Table 4.7

Good Practice in Financial Management and Accounting

Operational area	Practices
Investment	• Careful investment planning based on a realistic assessment of safety, liquidity needs and returns in that order • Limits on exposure to a particular instrument or institution • Limits on non-portfolio assets to less than 15-20% of total assets
Financing	• Comprehensive planning with scientific forecasting • A long term planned approach to fund-raising; proper contingency measures like cash credit facilities

Operational area	Practices
	• A financing strategy that entails use of multiple and stable sources of funds leading to funding risk mitigation • Analysing working capital needs and maximising efforts to attain a stable liability structure – even while generating sufficient funds with an optimal cost and conditions
Asset management	• Clear strategy to protect and manage assets through measures such as internal audit, portfolio tracking, portfolio diversification and client level insurance • Use of current accounts for collection • Limits for branch office bank accounts
Accounting	• Cash basis for recognition of interest income on loans except in cases where loans are repayable in quarterly, half-yearly or yearly instalment basis – cash-based recognition of income is a commonly used practice and represents a conservative way of reporting income • Treating grant inflows as non-operational income and reporting these inflows after determining operational profitability • Providing a detailed disclosure statement with regard to the accounting policies adopted and also providing details of each account head through schedules to the financial statements • Standardising and clearly defining the scope of an external audit through the use of a formal contracting system

Source: M-CRIL, 2003. "Improving Microfinance Practice"

Financial management and accounting are inter-related and key functional areas for all institutions engaged in financial intermediation. With a greater scale of operations, increased reliance on commercial funds that provides a platform for attaining high levels of outreach, financial management is now attracting the requisite degree of attention. The trend to commercialisation is also leading to greater recognition of the need for sound accounting practices.

With the scaling up of operations the following trends can be observed in financial management practices:

a. *Separately dedicated professional staff and department for financial management*;
b. *Cash management* is fast becoming an important aspect of financial management in microfinance. Clear cash transfer procedures, specific cash holding limits

and emphasis on the optimal utilisation of excess cash are becoming the norm in most progressive MFIs.

c. *Cheque-based disbursement and repayment:* Some MFIs have now moved towards a cheque-based system of loan disbursement and repayment. Apart from enhancing cash control, this reduces the delays in encashing cheques and allows for the speedy transfer of cash.

d. *Accounting*: Documented accounting practices with increasing emphasis on disclosure.

4.4.3 Requirements with Respect to Various Legal Forms

Regulations for societies and trusts do not provide any guidelines for financial management and accounting policies specific to the microfinance business. The emphasis in these regulations is largely on the annual accounts and financial reporting in prescribed formats. NBFC regulations, as discussed in Sections 2 & 3, provide various guidelines on prudential norms, accounting practices and reserve requirements (in the case of deposit-taking NBFCs) asset-liability management and reporting formats. Cooperative banks, like NBFCs, are subject to RBI regulations and are supervised by NABARD along with their state cooperative departments. Such banks need to follow the specified norms on disclosure, reserve maintenance and prudential norms. However, these standards are not applicable to legal forms like cooperatives and mutually-aided savings and credit cooperatives. While MFIs established as societies and trusts are able to get away with relatively ineffective accounting practices, this is not so easy for NBFCs and cooperative banks since these are subject to scrutiny by supervisors and regulators.

4.5 INTERNAL AUDIT AND CONTROL

The Basel Committee on Banking Supervision defines internal control[46] as "a process, effected by an entity's board of directors/trustees, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Verify the efficiency and effectiveness of operations.
- Assure the reliability and completeness of financial and management information.
- Comply with applicable laws and regulations.

This definition reflects certain fundamental concepts:

a. Internal control is a process. It is a means to an end, not an end in itself.
b. Internal control is effected by people. It is not policy manuals and forms, but people at every level of an organisation.

[46] 1998. Framework for Internal Control Systems in Banking Organisations. Basel Committee Publications No.40,

c. Internal control can be expected to provide reasonable assurance and increased probability, not absolute assurance, to an entity's management and board.

Internal control comprises the following five inter-related components:

a. *Control Environment:* The core of any organisation is its people - their individual attributes, including integrity, ethical values and competence largely determine the environment in which they operate.
b. *Risk Assessment:* Establishment of mechanisms to identify, analyse and manage related business and operating risks.
c. *Control Activities:* Establishment and implementation of control policies and procedures to help ensure that the actions identified by management as necessary to address risks and obtain the specified goals are effectively carried out.
d. *Information and Communication:* Surrounding these activities are information and communication systems. These enable the organisation to capture and exchange the information needed to conduct, manage and control the MFI's operations.
e. *Monitoring:* The entire process must be monitored, and modifications made as necessary. In this way, the system can react dynamically, changing as conditions warrant.

4.5.1 Current Status of MFIs on Internal audit and control

As in the earlier sub-sections, there is some indication here also that companies perform better, albeit because it is the better MFIs that have transformed into the more professional legal forms (Table 4.7). The lack of professionalism among MFIs registered as societies and trusts continues here. This results in a significant number of such MFIs having ineffective internal audit and control systems.

Table 4.8

Assessment of Internal Control Systems of Indian MFIs

Performance	Trusts/ Societies	Cooperative/ MACTS	NBFCs/ Sec 25 Co.	Total
Excellent	0	0	1	1
Good	9	1	5	15
Average	15	5	6	26
Poor	73	11	1	85
Total	97	17	13	127

Source: M-CRIL Database

4.5.2 Best Practices and Emerging Trends in Internal Audit and Control[47]

Since microfinance is an activity with large volumes of small transactions and poorly educated clients, MFIs, irrespective of their legal form, need to put in place internal control mechanisms that first prevent, then detect, fraud and also ensure compliance with organisational norms.

Table 4.9 details the elements of best practices of internal control being followed by MFIs in India.

Table 4.9

Best Practices in Internal Audit and Control

Operational area	Practices
Control environment	• The Board has an Audit Committee or a member responsible for internal audit and to keep a check on the internal audit team. This lends the internal audit department more credibility. • The internal audit department reports directly to the board and reports cannot be influenced by senior management. This creates an environment of autonomy and fair play amongst the junior staff and management. • An environment of zero-tolerance for misappropriation of funds.
Risk assessment	• Multiple levels of evaluation including corroboration of client data with guarantors and drawing from the experience of other staff. • Cash flow-based appraisal to determine absorption capacity and repayment potential. • Assess the ability of the co-obligant to repay. • Monitoring geographical diversification of portfolio to reduce the risk associated with excessive concentration in a single area· • Tracking the movement of overdues through an ageing analysis to assess delinquency risk
Control activities	• Stipulated maximum period for loan utilisation. • Thorough loan utilisation checks – MFI may check with the supplier from where the borrower is expected to acquire the machine, inputs or other commodities that serve the purpose for which the loan is extended.

[47] Adapted from M-CRIL, 2003. "Improving Microfinance Practice"

Operational area	Practices
	• Standard process for dealing with non-utilisation. • Quick field-level detection of overdues. • Zero tolerance policy to tackle overdues. • Standardised follow-up process.
Information and Communication	• Documented process for an organisation with an internal audit team. • Orientation to operations for internal auditors. • Result of audit shared with branch.
Monitoring	• Audit compliance follow-up.

Source: M-CRIL, 2003. "Improving Microfinance Practice"

Due to the growing size of Indian MFIs, increasing attention is being paid to internal control as a critical management function. This has led to a number of new developments that, though still relatively tentative, suggest the following practices are becoming common:

Involvement of the board of directors and senior management in control activities: As a result of the growing importance of internal control, board members and senior management are being made directly responsible for overseeing/managing control systems. The concept of a Audit Committees of boards is becoming accepted and enables a clear delineation of internal control from other operations.

Separation and professionalisation of the audit team: Until now most MFIs have treated internal audit as ad-hoc checks which were conducted by the senior management and some other staff from a different area. Now MFIs are making internal audit a regular feature and creating separate in-house/out-sourced audit teams (manned by professionals) to undertake this task.

Operations/internal audit manual: To communicate issues related to operational policy and to ensure proper compliance, MFIs are developing detailed operations and audit manuals. This is resulting in better understanding of policy at the operational level and is making it easier to spot non-compliance. Recording and transaction of management procedures are increasingly being clearly laid-out to regulate compliance.

Business planning: To monitor target achievement and progress, MFIs are introducing comprehensive business planning procedures with participation from all levels of the organisation. This results in realistic plans that have the support of operating staff. Such plans help in spotting variances for initiating detailed checks and corrective measures.

4.6 THE IMPORTANCE OF MANAGEMENT SYSTEMS TO MFI OPERATIONS

Microfinance being a financial business requires some management expertise apart from sound financial knowledge and accounting discipline. While the development approach is essential for a client-focused business like microfinance, systemic strength is required to scale-up the operations to a significant level and enhance outreach. As the discussion in the above sections indicates, Indian MFIs have a very strong developmental perspective. While their client focus has rarely been in doubt, their lack of management strength has always impeded their growth. This problem has been reinforced by the unsuitability, for this purpose, of the legal and regulatory framework.

It is apparent from the discussion in this section that of the 127 MFIs rated by M-CRIL in India (until December 2004), not more than 15 have sound management practices and adequate techno-managerial capabilities. Considering the size of the microfinance market and the present (relatively limited) outreach of MFIs in India, this position is far from satisfactory. The lack of professionalism among MFIs has always been a matter of concern for bankers, donors and other (more commercial) investors in the microfinance industry. As a result, not only do most MFIs face difficulties transforming to the more regulated and professional forms of legal structure represented by NBFCs, they also face difficulty in raising funds for on-lending. While there is a need for a legal framework in India that creates a facilitating environment for the establishment of MFIs, the healthy and steady growth of the sector also requires the establishment of more professional management systems that can enable growth and generate confidence amongst investors. These are the primary requirements in India today for increasing the outreach of microfinance to the large majority of the 60-70 million poor families in the country.

5 International Experience of the Effect of the Regulatory Framework on the Choice of Legal Form[48]

This section discusses international experience of the effect of regulatory frameworks on the choice of legal form by MFIs. It shows that a number of countries have introduced regulatory frameworks for the provision of microfinance services. The experience has been that, contrary to the fear of central banks, while these frameworks have enabled transformation of some institutions, they have not resulted in large numbers of MFIs needing to be supervised.

The earliest initiatives to bring microfinance under formal regulation and supervision were undertaken in Latin America. These entailed either the registration of MFIs as licensed commercial banks, as private financial funds (PFFs) or as regulated private finance companies (*Sociedad Financiera de Objeto Limitado*). Essentially, a PFF (in Peru for instance) has to be a corporation with a minimum paid-up capital equivalent to US$1 million, just one-third of the amount required for a commercial bank. Table 5.1 contains the minimum capital requirements for commercialisation in other countries of the region. In addition, however, there is a stringent constraint on operations as the maximum portfolio allocation to loans is just twice the value of equity. PFFs are basically subject to the supervision methods applied to banks supplemented by special methods developed for MFIs including assessment of the credit methodology and visits to clients.

Table 5.1

Minimum Capital Requirements for Commercialisation

Countries	Financiera(US$m)	Commercial Bank(US$m)
Bolivia	1.0	5.6
Ecuador	1.3	2.6
El Salvador	1.0	2.5
Honduras	5.0	8.0
Mexico	2.2	N/A
Peru	N/A	5.6

The trend of regulated microfinance started in Bolivia in 1992 when the microfinance activities of the NGO Prodem were transformed into BancoSol, which was registered as a licensed commercial bank. In 1995, in Ecuador, Banco Solidario was established as a

[48] This section is partly adapted from a discussion paper on the regulation and supervision of microfinance in as part of a Donor Review of Microfinance in Bangladesh by David Wright and Dewan Alamgir. M-CRIL made a significant contribution to the original paper.

commercial bank while Procredito, Bolivia was transformed into Caja los Andes, the first organisation to become a *Fondo Financiera Privado* (Private Financial Fund - PFF) under new legislation to create a specific structure for regulated non-bank MFIs. Also in 1995, Calpia was established as a *Financiera* in Ecuador, FINSOL in Honduras was established in 1999 while in Peru the NGO ACP gave birth to Mibanco as a commercial bank in 1998, and in Mexico the NGO Compartamos was transformed into a *Sociedad Financiera de Objeto Limitado* as a regulated private finance company in 2001.

As with NBFCs in India, one difficulty during the process of licensing and approval is mobilising the capital and creating the ownership structure required to satisfy regulatory requirements. "Ensuring adequate capital provides protection to institutions against various risks, allows for absorption of losses and, therefore, instills confidence amongst investors, lenders, clients and regulators. The question in microfinance is "what is an *adequate* level of capital?" It is widely accepted that the minimum capital requirements for specialised MFIs need not be as high as those for full service commercial banks because of the low portfolio size and the fact that the portfolio is not concentrated in a few large loans. Levels that are too high may discourage MFIs from commercialisation while low levels may allow unqualified entrants and also may not provide enough control incentive to owners."[49] As is apparent from Table 5.1, the minimum capital requirements for MFI transformation are quite high in most Latin American countries and these effectively limit entry of large numbers of MFIs into the regulated financial sector.

On the other hand, it has been argued that these levels of capitalisation in Latin America have been good for the microfinance sector. An article in the November 2002 issue of the MicroFinance Bulletin by Damian von Stauffenberg of MicroRate describes the changes that have taken place in Latin America as a result of such specialised banks being created. In 1997, of 29 MFIs that were assessed by MicroRate, most were NGOs. By 2001, 20 of these had become formal (regulated) institutions. These 20 regulated MFIs had an average debt/equity ratio of 4.5:1 compared to the 1.3:1 average ratio of the nine remaining NGO-MFIs. As a result of the additional resources, the 20 regulated MFIs on average were more than three times the size of the NGOs. However, the causality here needs to be viewed with caution since it is more than likely that only the largest of the NGOs were in a position to transform.

In Africa, a number of countries have started to put regulatory frameworks for microfinance into place. Particularly advanced in this field are Uganda and Ethiopia. "There are presently over 500 organisations in Uganda offering microfinance, together providing financial services to approximately 550,000 clients, the majority being women. Group lending is the predominant lending methodology using a blend of solidarity groups and village banking. Many MFIs require clients to deposit compulsory savings

[49] *Ibid.*

that are then locked in and not made available to the client until s/he has repaid the MFI loan. MFIs are not legally allowed to mobilise savings and on-lend them, leaving them operating either outside the legal framework or within traditional cooperative or formal sector banking laws. Only two organisations fall in the latter category and are currently regulated by the central Bank of Uganda (BoU) – one commercial bank, Centenary Rural Development Bank (CERUDEB); and one specialised microfinance credit institution, Commercial Microfinance Limited (CMFL).

"As the microfinance sector has grown, there has been increasing recognition of the need for change due to the fact that:

a. MFIs' emphasis on credit often exclude the risk-averse poorest who would rather save in order to meet future needs and crises than to incur debt through getting a loan. But the legal framework has prohibited MFIs from offering voluntary savings services;
b. There has been increasing pressure from low-income clients in general to add more flexible savings services, thus providing depositors with security, convenience, liquidity and, ideally, some rate of return. Again the law has constrained this development; and
c. If priced correctly, savings instruments can contribute to institutional self-sufficiency and to wider market coverage.

"Realising the need for a user-friendly legal and regulatory framework, BoU issued the 'Policy Statement on Microfinance Regulation and Supervision' in 1999. On the basis of this, financial institutions were categorised into four 'tiers':

a. Commercial Banks, licensed under the Financial Institutions Statute 1993;
b. Credit Institutions, licensed under the Financial Institutions Statute 1993;
c. Microfinance Deposit-Taking Institutions (MDIs), to be licensed under the new Micro Deposit-Taking Institutions Act, 2002 (MDI Bill); and
d. Institutions involved in microfinance that do not qualify for Tier 1, 2 or 3, e.g. smaller NGOs, membership-based savings and credit associations, and community-based organisations (which will not be regulated or supervised by the Bank of Uganda)"[50].

The MDI Bill was introduced in the Ugandan Parliament in 2002 and then went through an extensive process consultation during which MPs had to be convinced of the need for such legislation. Its impact on the choice of legal form is yet to be seen.

[50] Ibid.

Experience of the effect of regulation on the choice of legal form in selected countries of South and South-east Asia is summarised in Table 5.2 on the following pages. It is apparent from the table that:

a. A number of countries in Asia have legislation and/or regulatory frameworks that are specifically designed to promote outreach beyond the traditional markets served by commercial banks. Prominent amongst these are the BPRs of Indonesia and the Rural Banks of the Philippines.
b. Where such frameworks are not specifically restricted to microfinance, they have resulted in the creation of large numbers of FIs with substantial governance problems and have also resulted in over-stretching the supervisory resources of central banks.
c. However, where these frameworks are limited to and specifically designed for enabling the provision of microfinance, the situation is very different. Relatively few MFIs are able to qualify for registration in their ability both to raise adequate capital and to satisfy the management requirements of regulatory authorities. Thus, there are just six microfinance-oriented rural banks in the Philippines, nine licensed MFIs in Cambodia, five private development banks in Nepal and just five microfinance banks in Pakistan (not included in Table 5.2).

Everywhere, central banks (and supervisory authorities) are still gaining the experience necessary to undertake effective yet supportive prudential supervision of regulated MFIs. A study of the costs and benefits of supervision, undertaken in Latin America,[51] found that MFIs believe that from their perspective the benefits of being regulated outweigh the cost.

[1] Theodore L. and Loubiere J.T., *The Experience of Microfinance Institutions with Regulation and Supervision: Perspectives from Practitioners and a Supervisor,* October 2001

Table 5.2: Regulation in Other Asian Countries (and implications for the selection of legal form)

	Regulation/supervision of NGO MFIs	Legislation enabling MFI banks or other MFI licenses	Quality/extent of supervision	EIR and interest caps	Implications for choice of legal form
INDONESIA					
INDONESIA	• Local village credit boards (BKD) providing mainly credit + forced savings – supervised by Bank Rakyat Indonesia (BRI) for Bank Indonesia.	• Provincial governments given an opportunity to establish NBFIs (1970) – over 2,000 LDKPs.	- Bank Indonesia representative on bank boards.	BPR – <u>Savings</u> 10%-17% p.a	Since the introduction of BPRs, entry into micro-banking has been relatively easy for private operators in addition to the LDKPs established by provincial governments. The minimum capital requirement for BPR operations in rural areas is very low. This resulted in the establishment of >2,000 BPRs.
	• Local non-bank financial institutions (LDKP) (Banking Act No. 14 of 1967) regulated by the Ministry of Home Affairs and provincial governments; supervised by provincial development banks.	• Banking deregulation in 1988 lowered entry barriers for NGOs to BPRs – now over 2,000 BPRs.	- Emphasis on direct inspections but not very effective as Bank Indonesia's capacity to monitor smaller banks like BPRs is limited.	<u>Loans</u>28%-63% p.a. interest rate on the basis of purpose.	
	• BPRs – local level micro-banks – (established by the banking reforms of October 1988, recognised as secondary banks by the Banking Act of 1992) regulated by Bank Indonesia; minimum capital required - $60,000.	• Deposit protection offered by BI.	- Compliance and risk-based supervision complementary.	No interest caps of any sort.	Supervision and governance norms are relatively lax but this has meant that many of the BPRs are quite weak institutions.
	• Cooperatives are subject to the cooperative law (No12 of 1967) regulated by the Department of Cooperatives. • Pawnshops regulated by the Ministry of Finance.	• Banking Act No.10 of 1998 requires any party mobilising deposits from the public to obtain a business license from Bank Indonesia.		No real interest in this issue from politicians or media.	Under new regulations, NGO-MFIs can no longer operate from 2008 and must transform either into cooperatives or BPRs

	Regulation/supervision of NGO MFIs	Legislation enabling MFI banks or other MFI licenses	Quality/extent of supervision	EIR and interest caps	Implications for choice of legal form
			C A M B O D I A		
C A M B O D I A	▯ All NGO-MFIs are registered with the National Bank of Cambodia (NBC). ▯ MFIs able to meet the licensing requirements are specifically permitted to provide savings as well as credit services. Minimum capital requirement: US$65,000; each licensed institution maintains 5% of its registered capital as a permanent reserve amount with NBC; capital adequacy ratio (CAR) – 20%; liquidity ratio – 100%; loan loss reserve requirements based on ageing, >90 days – 20%, >180 days – 50%, >360 days – 100%.	▯ License issued to <u>MFIs</u> by NBC. The license is for a limited liability company or a cooperative. ▯ Licensing of <u>rural credit specialised banks</u>: capital requirement US$ 2.5 million not really MFIs Law on Banking and Financial Institutions, November 1999	- Qualifications of the director and members of the decision-making body need to be submitted and cleared by NBC while obtaining a license. - Only nine licensed MFIs; supervision reasonable though supervisors need additional training and experience	▯ EIR of around 45%. ▯ Foreign loan funds cheaper than mobilising deposits. ▯ No interest cap from NBC but informal pressure by government, politicians and press.	The licensed MFI route is increasingly popular though relatively few have the capacity to meet the equity and management norms. Only one or two more are likely to be licensed in the near future.
			N E P A L		
N E P A L	▯ NGOs operate under the Society Registration Act, 1978 and the Social Welfare Act, 1991. Regulated by the Social Welfare Council. ▯ MFIs licensed under the central bank law, the Nepal Rashtra Bank (NRB) Act for limited deposit taking from members and also	▯ <u>Limited banking licence for NGOs</u> and cooperatives by NRB. ▯ Financial Intermediary Societies Act, FISA, 1998 attempted to legitimise microfinance by making licensing mandatory but easy; provisions such as discretionary interest rate	- Mandatory priority sector lending – 12% of portfolio – by commercial banks is channelled through development banks, licensed NGOs and cooperatives at rates as low as 6-8%.	▯ MFIs charge 18-24%. ▯ No interest cap but it continues to be a moral obligation to limit interest rates and MFIs face pressure; interest exceeds	The limited banking licence for NGOs legitimises a considerable amount of NGO-MFI activity. Those who have the capacity and want to operate on a larger scale are able to establish development banks. There are now five non-government development banks in operation in addition to five regional Grameen Development Banks established by the central bank.

	Regulation/supervision of NGO MFIs	Legislation enabling MFI banks or other MFI licenses	Quality/extent of supervision	EIR and interest caps	Implications for choice of legal form
			CAMBODIA		
NEPAL	regulated by NRB – around 60-70 such MFIs. - Cooperatives registered under the Cooperative Act and some are licensed by NRB for deposit-taking as MFIs. - Development Banks established under the Development Banks Act, 1996 allows the establishment of financial institutions with capital requirement of just $133,000 compared to $3.3 million for commercial banks – not allowed to issue cheques or services other than loans and deposits.	controls and NRB responsibility for guaranteeing loans to MFIs made implementation impractical; law recently re-enacted to take out these provisions, not yet notified(but see column on interest caps for the real political problem in Nepal)	- NRB holds 60-75% shares in some of the Development Banks and appoints CEOs Reasonable supervision of Development Banks but not effective for MFIs.	15%, especially from Maoists,· NRB has the authority to ask licensed agencies to revise their interest rates under FISA, 1998.	
			PHILIPPINES		
PHILIPPINES	- NGOs involved in credit registered under the Securities and Exchange Commission (SEC) as non-profit non-stock corporate entities – unregulated since SEC acts as a corporate registry only; the Philippine Coalition for Microfinance Standards has introduced some self-regulatory measures	- More liberal licensing and branching of rural banks since 2000. A few of the larger MFIs have now converted into rural banks – CARD, Opportunity Microfinance Bank, ARDCI, Microenterprise Bank established within the past 3-4 years.	- A National Credit Council (NCC) in the Department of Finance established in 1993 to determine and recommend policy and regulation initiatives to the government; has introduced new, standard chart of accounts and accounting	- EIR ranges from 60-80% p.a. in different areas – often 3-6 month loans. - BSP is part of effort of National Credit Council to promote	The rural bank is a similar legal form to the BPR in Indonesia. Rural Banks have been relatively easy to establish though the central bank is now concerned that 800+ is too many and that many of these are too weak. It is encouraging amalgamation of rural banks though it is still encouraging the establishment of "Microfinance-Oriented Rural Banks" – with more than 50% of portfolio in micro-loans

	Regulation/supervision of NGO MFIs	Legislation enabling MFI banks or other MFI licenses	Quality/extent of supervision	EIR and interest caps	Implications for choice of legal form
PHILIPPINES					
PHILIPPINES	Credit unions and deposit taking cooperatives – lax approach to regulation by the Cooperative Development Authority (CDA); mainly checks compliance with registry rules and submission of annual reports, visits by CDA agents; BSP favours regulation but would like to leave regulation to the CDA Rural banks (~800 of them) regulated and supervised by the central bank, Bangko Sentral ng Pilipinas (BSP) – minimum capital requirements $64,000 to $640,000 depending on location (6th class municipalities to Metro Manila); CAR – 10%; reserve requirements, 2% on savings and time deposits, 7% on demand deposits; loan loss reserve requirements based on the extent of collateral.		rules for all types of MFIs.– Supervision of rural banks being strengthened but still relatively weak.	market-oriented microfinance· Some pressure from politicians, media to restrict interest rates but not supported by the government.	($2,500). So far there are six such rural banks. As elsewhere the cooperative sector is relatively weak.

The direct anticipated benefits of regulation include: increased access to capital; ability to provide a broad product mix, especially savings and payments; and improved credibility. In addition the MFIs also cited increased profitability, better general understanding of MFIs and their clients, and the ability to be more innovative in product offerings. The direct costs, on the other hand, include adding and training staff, modifying or replacing MIS, and supervisory fees. Indirect costs may include decreased flexibility and increased workload of staff in dealing with examiners. A particular problem of these Latin American MFIs was that they were the first in their countries to obtain licences and therefore had to break much new ground. This experience is now being replicated in countries like Cambodia, Nepal, Pakistan and the Philippines (discussed above) where regulators and supervisers have only recently started to learn to work with regulated MFIs.

As Compartamos (Mexico) commented:

"The process was long and tedious (lasting more than two years). The principal obstacles were: the low priority the authorities placed on this, given the fact that the regulatory staff has a high volume of work; and the supervisors' lack of knowledge of microfinance."

Essentially, it is apparent from international experience that while the expected benefits of transforming to a regulated legal form are high, the short-term costs could be significant for the pioneering MFIs that transform to these structures. Nevertheless, it is apparent from the experience both of Latin America and of countries such as Cambodia that transformation has a substantially impact through increased outreach. To the extent that the pioneering MFIs are the strongest ones in each country – in terms of both finances and management – the costs of undergoing the learning process required to develop comfort and experience amongst central bank supervisers are likely to be worthwhile for garnering the benefits of transformation.

ANNEXURE 1

A DISCUSSION ON THE LEGISLATION AGAINST THE CHARGING OF USURIOUS INTEREST RATES

The Indian Moneylenders' Act 1918 forms the base of all legislation against the charging of usurious interest rates in the country. Until the early part of the 20th century, in the absence of a proper banking network, poor farmers and petty traders were exposed to the excesses of moneylenders. Legislation to bring the charging of usurious interest rates under some control was enacted in 1918. After Independence and subsequently the enactment of the Indian Constitution, this subject was brought under the purview of state governments. Following this, various state governments have brought their own legislations and ordinances to curb the activities of moneylenders.

The Act has implications for the activities of some MFIs as well. MFIs registered as Societies and Trusts can easily be targeted under the provisions of the state-level legislations and ordinances. Since the status of microfinance as social work and an activity for the alleviation of poverty has never been under any regulatory framework, such institutions can be accused of engaging in unregulated moneylending activity. In this context, the discussion below covers some of the provisions of the Tamil Nadu Prohibition of Charging of Exorbitant Interest Ordinance, 2003 – a matter of considerable discussion in the microfinance sector at present. The explanatory statement of the ordinance says that

"In order to obviate the difficulties experienced by the public at large, falling prey to any person charging exorbitant interest like daily *vatti, kandhu vatti, meter vatti* and *thandal*, the government have decided to prohibit lending money for such exorbitant interest and to provide for the stringent punishment therefore and decided to enact a new legislation for the purpose."

The above statement appears to carry all the noble intents of preventing the exploitation of poor villagers, et al. Section 3 of the ordinance says: "No person shall charge exorbitant interest on any loan advanced by him." The term exorbitant interest is defined by the Section 7 of the Tamil Nadu Moneylender's Act 1957. It states:

a. No moneylender shall charge interest on any loan, at a rate exceeding such rate as the government may, by notification, fix from time to time. Provided that the rate of interest as may be fixed by the government shall be correlated to the current bank rates of lending as may be fixed by the Reserve Bank of India, from time to time.

b. A moneylender may demand and take from the debtor such charges and in such cases, as may be prescribed.
c. A moneylender shall not demand or take from the debtor any interest, profit or the sum whatever in excess of that payable under sub-section 1.

Clearly the state government has assumed the role of fixing interest rates for moneylenders. Needless to say, the interest fixed by the governments is not scientific and hardly takes into account the various costs and risks involved therein. Moreover, they are rarely followed, as is apparent from the findings of various studies of interest rates being charged by moneylenders. It would be interesting to see what the laws of some other states say on this. The Rajasthan Moneylender's Act 1963 defines interest as any sum, whatsoever name called, in excess of the principal paid or payable to a money lender in consideration of or otherwise in respect of, but does not include any sum lawfully charged by a moneylender for or on account of costs, charges or expenses in accordance with the provision of this Act or any other law for the time being in force. Similarly, the Karnataka Moneylender's Act, 1961 defines interest as the return to be made over and above what was actually lent, whether the same is charged or sought to be recovered specifically by way of interest or otherwise, but does not include any sum lawfully charged by a moneylender for or on account of costs, charges or expenses in accordance with the provisions of this Act, or any other law for the time being in force. Clearly, the government retains the right to play around with the interest rates by bringing in ordinances from time to time. While this provision appears to be in the public interest, this also leaves the possibility of other institutions becoming easy prey.

The Tamil Nadu Moneylender's Act 1957 also requires the moneylenders to obtain a license from the state government and follow some requirements for registration as a moneylender.
There is a list of the requirements that needs to be followed for obtaining a license. Section 3 of the Moneylender's Act states

i No person shall on and after the date on which the provisions of this Act are brought into force in any area carry on or continue to carry on business as a money lender at any price in such area except under and in accordance with the terms of a license.
ii Where a money lender has more than one shop or place of business whether in the same town or village or in different town or village or in different towns or villages, he shall obtain a separate license in respect of each such shop or place of business.
iii Where a moneylender is a registered firm the license shall be obtained in the firm's name.

iv Where a moneylender is an undivided Hindu family, the license shall be obtained in the name of the manager or the Karnavan or the yajaman, as the case may be described as such in the license.

v Where a moneylender is any other association of individuals, not required to be registered under the Companies Act, 1956, a separate license shall be obtained by each such individual in his name describing himself as a member of the association, provided that nothing contained in this sub-section shall affect the operation of Section 59of the Indian Partnership Act, 1932.

Similarly, Section 6 of the Bombay Moneylender's Act, 1946 states that every moneylender shall annually before such date as may be prescribed make an application in the prescribed form for the grant of a license to the Assistant Registrar of the area (within the limits of the place where he intends to carry on the business of money-lending or if he intends to carry on such business at more than one place in the area, the principal place of such business is situated). The above provisions clearly require all the MFIs (except cooperative societies, cooperative banks, NBFCs and Section 25 companies) to obtain a license for carrying out their business – if they are practicing professional money lending. The table on the following page provides details on some of the important regulatory provisions of different state moneylenders' acts. Given the debatable nature of microfinance as a charitable activity, societies and trusts can easily be targeted under the provisions of this Act notwithstanding the fact that the MFIs are trying to provide an important financial service to poor clients and their objective is to alleviate poverty by providing credit to low-income clients.

Annex 1 : Table 1
Important Features of Different State Moneylender's Acts

State Acts / Important Features	Registration & Registration Authorities	Maintenance of Liquid Assets	Maximum Rate of Interest	Minimum Transaction Amount through Cheques
U P Regulation of Moneylenders' Act 1976	Supreme authority in the state being the Registrar General of Moneylending; followed by officials of smaller denomination. Application to be made to the concerned authority in the prescribed format along with the required stamp fee; if the principal of the business is in the state of UP.	At least 25% of the deposit liabilities held by the money-lender. Also the amount of non-collateral advances should not exceed 50% of the total deposit liability of the money lender.	State government to announce the rates of interest for the secured and unsecured loans based on the bank rates.	Rs 1,000 Only.
Bengal Moneylender's Act 1940 (with an amendment to bring in the commercial loans also under the purview of this act in 1981)	State Registrar to be supreme authority in the state; to be appointed by the government of the West Bengal. Also the inspectors to be appointed for specific geographical jurisdiction to take care of such businesses. Application for registration to be made to these inspectors in specified formats.	No such provision	10% per annum for secured loans and 12% per annum for unsecured loans. In the case of commercial loans (meant for commercial or business use) - 17.5% per annum for unsecured loans and 20% for secured loans	No such provision

State Acts / Important Features	Registration & Registration Authorities	Maintenance of Liquid Assets	Maximum Rate of Interest	Minimum Transaction Amount through Cheques
Kerala Moneylenders' Act 1958	Registrar to be appointed by the state government. The application for license/ registration to be made to the registrar on the prescribed format alongwith the stamp duty fee to be charged on the basis of the amount to be lent during the year. The license to be renewed every year.	No provision; though licensed money lenders allowed to accept deposits.	Should not exceed 2% the rate of interest being charged by the commercial banks in the state.	Not specified.
Karnataka Moneylender's Act 1961	State government to appoint Registrar General, who would be the supreme authority in the state on the matters of money lending; to be followed by Registrars and Sub Registrars. Application to be made to the concerned authority for the geographical area and the license fee or the stamp duty to be based on the proposed working capital of the moneylender.	Money lender may hold security; but no liquid deposit from the debtor. Any liquid deposit to be credited from the borrowed amount.	State government to fix the maximum rate of interest from time to time based on the ongoing bank rates.	No such provision.

ANNEXURE 2

Exemptions Available to Companies Registered under Section 25 of the Companies Act, 1956

S.No.	Notification number & date	Provisions dispensed with	Provisions from which exemption has been granted	
			Section	Nature of provisions
1	Sec 263A inserted by Act No 65 of 1960 (28.12.1960)	Provisions relating to putting a resolution to vote (provisions in the Articles of such company if any for election of directors by ballot shall prevail).	177	Voting to be by show of hands at first instance.
2	-Do-	Provisions in articles of association relating to electing the directors by ballot at AGM shall prevail.	255, 256, 263	Manner of appointment of directors.
3	SO-1578 GI dated 8.7.1961	Whole provisions of Section 147 regarding publication of name and address by a company.	147	Publication of name and address of company.
4	-Do-	Whole provision relating to filing with the Registrar a return stating names of members and other details.	160(1)(aa)	Annual return to accompany details.
5	-Do-	Whole provisions relating to holding of AGM during business hours and on a day which is not a public holiday.	166(2)	AGM to be called during the business hours and on a day which is not a public holiday.
6	-Do-	Provision relating to 21 days clear notice for calling a general meeting. (Only 14 days notice may be given for calling AGM).	171(1)	Length of notice for calling meeting.
7	-Do-	Provisions relating to retention of books of accounts (books of accounts relating to a period of not less than four years need only be preserved).	209(4A)	Retention of books of account for a period not less than eight years.

S.No.	Notification number & date	Provisions dispensed with	Provisions from which exemption has been granted	
			Section	Nature of provisions
8	-Do-	Whole provisions relating to leaving a notice signifying candidature for office of director.	257	Right of persons to stand for directorship..
9	-Do-	Consent for directorship not required to be filed with the company	264(1)	Consent of candidate for directorship to be filed with the company and consent to act as a director to be filed with Registrar.
10	-Do-	Provision relating to holding of meeting of board of directors provided at least one meeting should be held within every six calendar months.	285	Meeting of board of directors should be held once in every three calendar months.
11	-Do-	Provisions relating to holding of meeting of board of directors (quorum at a meeting of board shall be eight members of ¼ of its total strength subject to minimum of two).	287	Quorum of meetings.
12	-Do-	Interest to be disclosed in the specified manner only in respect of contracts to which Sec297 (1 &3) is applicable.	299	Disclosure of interests by directors, etc.
13	-Do-	Register of contracts to which Sec 297(1&3) is applicable only need to be maintained.	301	Maintenance of register of contracts, companies and firms in which directors are interested.
14	-Do-	Provisions relating to sending an abstract terms of contract or variations of contract (such information need not be sent). Provisions relating to recording minutes. If the articles provide for confirmation of minutes by circulation, minutes may be recorded within 30 days of conclusion of every meeting.	302(2)	Abstract of terms of contract or variations of contract for appointment of managing director and interest of any director therein to be sent to the members.
15	SO-2767 dated 5.8.1964	Provisions relating to obtaining government approval for increasing number of directors (Govt. approval not required).	193	Minutes of proceedings of general meeting of board and other meetings.

S.No.	Notification number & date	Provisions dispensed with	Provisions from which exemption has been granted	
			Section	Nature of provisions
16	-Do-	Provisions relating to obtaining government approval for increasing number of directors (Govt. approval not required).	259	Increase in number of directors to require government sanction.
17	-Do-	Provisions relating to exercising/deciding of following powers at a board meeting: a. to borrow money otherwise than on debentures; b. to invest funds of the company; c. to make loans (These powers may be exercised by circulation instead of at a meeting.)	292	Certain powers to be exercised by board only at a meeting.
18	GSR No 73 dated 30.12.1965	Copies of balance sheet and auditors report should be sent not less than 14 days before the date of general meeting.	219(1)	Right of members to copies of balance sheet and auditor report.
19	SO-35E dated 9.2.1976	Provisions relating to appointment of a Secretary (Person appointed to perform the duties of Secretary need not possess prescribed qualification).	2(45)	Secretary of a company to have prescribed qualification.

Source: Nabhi's Formation and Management of a Society, September 2004

ANNEXURE 3

A NOTE ON THE RATING PRINCIPLES AND FRAMEWORK OF M-CRIL

Governance and strategy: The assessment depends on the quality and appropriateness of the board composition, its role and overall organisational strategy.

Management systems are rated on the quality of human resources, the strength of critical systems like accounting and management information. The performance of the MFI on staff productivity and ensuring compliance is also assessed.

Financial performance evaluation requires the rating team to construct financial statements, based on internationally accepted prudential norms, to present a fair picture of the operations. In case of organisation's doing more than one activity, the costs are allocated based on a field assessment of usage. These are then used to assess the MFI's financial strength based on aspects like repayment performance, asset quality, liquidity, asset liability management (ALM) and profitability.

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