Chapter 4

LEGAL FRAMEWORK

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Preceding chapter presents an overall idea about the research design of this study with the explanation, in detail. This chapter is going to discuss about the development in the legal frame work with reference to microfinance.

Microfinance came into existence, and it started growing, according to the need and convenience. On analyzing the data of last five years (2008-2012), the total gross loan portfolio of the MFIs has observed an up ward trend *i.e.* ₹59.54 billion (2008) to ₹175.65 (yr) billion. When MFIs are studied with their legal forms, it shows rising trend for NBFC form of organization. It increases from 9.46% (2006) to 65.57% (2012). It is the indication of boost in commercialization of microfinance over a period of time.[1-7]

When the microfinance started growing by many fold, institutions also started burning their fingers from borrowers' side. Moreover, the absolute commercial approach towards funding of microfinance can equally not serve the purpose. In the light of the same, the RBI and NABARD felt a need to regulate the MFIs. The present chapter discusses the legal regulatory framework as applicable to MFIs.

India with a population of around 300 million poor people has emerged as a large potential market for the microfinance sector, which is attracting funding from various sources. To enable the country to leverage this interest and use it to progress towards the goal of financial inclusion, it is important to develop a regulatory structure for the sector, for number of reasons. First, regulation is needed to enable microfinance institutions (MFIs) to offer savings services, the lack of which is a major shortcoming of the sector. Second, with the entry of commercially-oriented participants, the need for supervision and consumer protection is even more pressing. Third, with MFIs broadening their range of services to include services such as insurance and pension products, coordinated regulation of the sector is required. Finally, given the diversity of legal forms of MFIs, a uniform regulatory framework would enable a level playing field and prevent regulatory arbitrage.[8]

4.1 Evolution of Microfinance

Microfinance is of ancient origin in India. The informal financing system can be traced to the era of Kautilya in the fourth century B.C. Since long time, traders and moneylenders have traditionally provided credit to the rural poor. The first effort in institutionalizing rural credit was made by the Government of India in the first decade of the last century with the passing of the Cooperative societies Act in 1904 to support the country's predominantly agricultural economy. In 1950, the creation of a nationwide network of rural cooperative banks was an attempt to improve financial access for India's poor (75% rural). Government of India introduced social control in 1967 and later nationalization of major commercial banks was occurred. These banks were also directed to involve themselves in rural lending. Later in 1975, Government of India also introduced a specialized state sponsored, regionally based and rural oriented Regional Rural Banks (RRBs) with the objective of accelerating rural economic development of the identified target groups i.e., weaker sections comprising small and marginal farmers, agricultural labourers, artisans, small entrepreneurs etc. Despite having a wide network of rural bank branches in India, a very large number of poor especially women continued to remain outside from the formal banking financial system. Therefore, a need of financial inclusion was felt with alternative systems and procedures, saving and loan products, other complementary services and new delivery mechanisms, which would fulfil the requirement of the poor. The Regional Rural Banks (RRBs) were set up in 1976, especially with a view to meet the credit requirements of the weaker sections of the society. In the early 1980s, the government of India launched the Integrated Rural Development Program (IRDP), a large poverty alleviation credit program, which provided government subsidized credit through banks to the poor. It was aimed that the poor would be able to use the inexpensive credit to finance themselves over the poverty line. Then in 1981, The National Bank for Agriculture and Rural Development (NABARD) came into existence and initiated new approach in the area of rural finance. In 1982 RBI transformed its agricultural credit department into the NABARD.[9]

4.1.1 Banking with Self-Help Groups

Self-help groups (SHGs) first emerged in MYRADA (Mysore Resettlement and Development Agency) in 1985. In 1986/87 there were some 300 SHGs in MYRADA's projects. Many had emerged from the breakdown of the large cooperatives organized by MYRADA. NABARD focused on supporting NGO (Non Government Organizations) initiatives to promote SHGs and on analyzing their potential and performance. In 1987 NABARD first put funds into the SHG/SAG* movement (in response to a proposal from

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Note: *= When these affinity groups emerged in MYRADA projects in 1984, largely as a result of the breakdown of the cooperative societies organized by MYRADA in its rehabilitation projects, they were called credit management groups and focused on the management rather than the provision of credit. When MYRADA entered into an agreement with NABARD to launch the research-and-development initiative related to these groups, the name was changed to self-help groups. NABARD provided MYRADA Rs 1 million in 1987 for this purpose. MYRADA continued (contd.)

MYRADA submitted in 1986). In 1987 NABARD provided MYRADA with a grant of 1 million Indian rupees to enable it to invest resources to identify affinity groups, build their capacity and match their savings after a period of 3-6 months. The grant was based on MYRADA's experience in promoting SHGs since 1985 and the initiative of the NABARD chairperson at the time, Shri P.R. Nayak.

As a result of the feedback from this initiative, in 1989 NABARD launched an action research of project in which similar grants were provided to other NGOs. After an analysis of the action research, and owing to the efforts of successive NABARD chairpersons and senior management, in 1990 RBI (The Reserve Bank of India) accepted the SHG strategy as an alternative credit model.[10] In 1991[11] (July 24) RBI advised all scheduled Commercial Banks (excluding RRBs) to actively participate in the pilot project which would be launched by NABARD.

Accordingly NABARD launched a pilot project in 1992[12] (February 26) with the flexible guidelines to enable participating banks and field level banks. The pilot phase was followed by the Working Group of NGOs and SHGs constituted by RBI, which came out with the wide range of recommendations on internalization of the SHG concept as a potential intervention tool in the area of banking with the poor. In 1996[13] (April 2), the RBI accepted most of the major recommendations and advised the banks to consider lending to the SHGs as part of their mainstream rural credit operations. The programme was upgraded to a regular banking program in 1996[14] (October 7). Based on very successful feedback of the pilot run of the Program, NABARD in 1998[15] crystallized its vision for providing access to 100 million of rural poor through linking of 1 million SHGs by 2008 (which was achieved in March 2004).

The evolution of SHG-Bank Linkage Programme could be viewed in terms of following three distinct phases:

Table 4.1 The Evolution of SHG Bank-Linkage Programme

Phase 1	Pilot testing during 1992 to 1995
Phase 2	Mainstreaming during 1996 to 1998
Phase 3	Expansion from 1998 onwards

Source: Pati A. P. (2010)[16]

to stress that members should be linked by affinity (mutual trust and support) and not simply because they were eligible beneficiaries. After 1999, when MYRADA realized that SHGs were being promoted without any concern for affinity and with little or no training to build their institutional capacity, MYRADA changed the name of the groups it promoted to 'self-help affinity groups' or SAGs. In the present document, the term SAG will be used throughout, except where it refers to the NABARD SHG-Bank Linkage Programme and in quotations.

4.1.2 Microcredit and Microfinance: Defined

The term "Microfinance" has been given a working definition by the Task Force on Supportive Policy and Regulatory Framework for Microfinance set up by NABARD in November 1998 as: "provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards".[17] The same definition is also given by RBI for the term Microcredit (RBI notification 2000, February 18).[18] However, microfinance is understood in a broader sense than that of micro credit. In fact, the MFIs (Microfinance Institutions) provide saving products, pensions, payment services, housing loans and other non-credit services as well such as capacity building, training, marketing of the products of the SHGs, micro-insurance, etc.

4.1.3 Financial Inclusion of Microfinance

C. Rangarajan (2008)[19] has submitted the report giving recommendations on Financial Inclusion with the main objective of extension the scope of activities of the organized financial system to include within its ambit people with low incomes. Through graduated credit, the attempt must be to lift the poor from one level to another so that they come out of poverty. However, the primary focus of the committee had been on improving the delivery systems (supply side), both conventional and innovative. The committee also proposed the constitution of two funds with NABARD – the Financial Inclusion Promotion & Development Fund and the Financial Inclusion Technology Fund with an initial corpus of ₹500 crores each to be contributed in equal proportion by GOI/RBI/NABARD. This recommendation has already been accepted by GOI. After showing the success of SHG-Bank Linkage Scheme in rural areas, the committee has recommended amendment to NABARD Act to enable it to provide microfinance services to the urban poor also. Thus, the committee had recommended adopting the concept of Joint Liability Groups (JLGs), an up gradation of SHG model, for purveying credit. The committee felt that MFIs could play a significant role in facilitating inclusion, as they are uniquely positioned in reaching out to the rural poor. Many of them have a greater understanding of the issues specific to the rural poor. Accordingly, the committee has recommended that greater legitimacy, accountability and transparency will not only enable MFIs to source adequate debt and equity funds, but also eventually enable them to take and use savings as a low cost source for on-lending. The committee also felt a need to recognize a separate category of Micro finance-Non Banking Finance Companies (MF-NBFCs), without any relaxation on start-up capital and subject to the regulatory prescriptions applicable for NBFCs. Such MF-NBFCs could provide thrift, credit, micro-insurance, remittances and other financial services up to a specified amount to the poor in rural, semi-urban and urban areas. Such MF-NBFCs may also be recognized as Business Correspondents of banks for providing only savings and remittance services and also act as micro insurance agents. The committee believed micro-insurance as a key element in the financial services for the people at the bottom of the pyramid. The poor face more risks than the well off. Therefore, the committee expressed the need to emphasize linking of micro credit with micro-insurance.

4.2 Legal Structure of Microfinance Institutions (MFIs)

Institutions providing all types of financial facilities under the head of microfinance are called microfinance institutions. MFIs are the institutions which have come up to fill the gap between the demand and supply of microfinance. The term MFIs was defined by the Task Force as "those which provide thrift, credit and other financial services and products of very small amounts, mainly to the poor, in rural, semi-urban or urban areas, for enabling them to raise their income level and improve living standards."[20]

4.2.1 Types of MFIs

This section deals with two parts A & B. Part A discusses about the MFIs classified based on the nature of organization while Part B discusses about the MFIs classified based on the size and nature of operation.

A MFIs based on the Nature of Organization[21]

Based on the nature of the organization MFIs are classified into following types such as NGO-MFIs; Non-Profit Companies as MFIs; Mutual Benefit MFIs and For Profit MFIs. Following lines explain about the same.

NGO-MFIs: There are a large number of NGOs that have undertaken the task of financial intermediation. Majority of these NGOs are registered as Trust or Society. Many NGOs have also helped SHGs to organize themselves into federations and these federations are registered as Trusts or Societies. Many of these federations are performing non-financial and financial functions like social and capacity building activities, facilitate training of SHGs, undertake internal audit, promote new groups, and some of these federations are engaged in financial intermediation. The NGO MFIs vary significantly in their size, philosophy and approach. Therefore these NGOs are structurally not the right type of institutions for undertaking financial intermediation activities, as the byelaws of these institutions are generally restrictive in allowing any commercial operations. These organizations by their charter are non-profit organizations and as a result face several problems in borrowing funds from higher financial institutions. The NGO MFIs, which are large in number, are still outside the purview of any financial regulation. These are the institutions for which policy and regulatory framework would need to be established.

Non-Profit Companies as MFIs: Many NGOs felt that combining financial intermediation with their core competency activity of social intermediation is not the right path. It was felt that a financial institution including a company set up for this purpose better does banking function. Further, if MFIs are to demonstrate that banking with the poor is indeed profitable and sustainable, it has to function as a distinct institution so that cross subsidization can be avoided. On account of these factors, some NGO MFIs have set up a separate Non-Profit Companies for their microfinance operations. The MFI is prohibited from paying any dividend to its members. In terms of Reserve Bank of India's Notification dated 13 January 2000, relevant provisions of RBI Act, 1934 as applicable to NBFCs will not apply for Non Profit Company. Following lines presents the provisions applicable to the Non-Profit Companies.

a) License under Section 25 of Companies Act, 1956,

b) Providing credit not exceeding ₹50,000 for a business enterprise and ₹1,25,000 for meeting the cost of a dwelling unit to any poor person.

c) Not accepting public deposits.

Mutual Benefit MFIs: The State Cooperative Acts did not provide for an enabling framework for emergence of business enterprises owned, managed and controlled by the members for their own development. Several State Governments therefore, enacted the Mutually Aided Co-operative Societies (MACS) Act for enabling promotion of self-reliant and vibrant co-operative Societies based on thrift and self-help. MACS enjoy the advantages of operational freedom and virtually no interference from government because of the provision in the Act that societies under the Act cannot accept share capital or loan from the State Government. Many of the SHG federations, promoted by NGOs and development agencies of the State Government, have been registered as MACS. Reserve Bank of India, even though they may be providing financial service to its members, does not regulate MACS.

For Profit MFIs: Non Banking Financial Companies (NBFC) are companies registered under Companies Act, 1956 and regulated by Reserve Bank of India. Earlier, NBFCs were not regulated by RBI, but in 1997 it was made obligatory for NBFCs to apply to RBI for a certificate of registration and for registration with RBI, NBFCs were to have minimum Net Owned funds of ₹2.5 million and this amount has been gradually increased to ₹20.0 million w.e.f. April 21, 1999. RBI introduced a new regulatory framework for those NBFCs who want to accept public deposits. All the NBFCs accepting public deposits are subjected to capital adequacy requirements and prudential norms. Many MFIs view NBFCs more preferred legal form and are aspiring to be NBFCs.

B MFIs based on the Size and Nature of Operation[22]

Regulation of MFIs depends upon their size and nature of operations. The Task Force classified MFIs as small MFIs below cut-off level of business and big MFIs above the cut-off level of business. According to the Task Force, MFIs with large area of operation and activities, need more regulation as compared to MFIs with small scale of activities. Task Force is, therefore, of the opinion that there should be a dividing line between "small" and "large" MFIs from the point of view of their operations, and more particularly mobilization of savings by them, as safety of the interests of the small savers is involved. The cut-off limit will also determine the extent of regulation and supervision requirements for the MFIs. Based on the type of financial services extended and the cut-off level of business, the MFIs can be divided into four classes for the purpose of regulation: MFIs purveying credit only; MFIs purveying credit and mobilizing savings from the clients/loanees (below cut-off limit); MFIs purveying credit and mobilizing savings from the clients/loanees (above cut-off limit); and MFIs purveying credit and mobilizing savings from the clients/loanees and general public.

Cut-off Level of Business: After examining the data from more than 350 agencies and field studies of SHGs and other types of ground level microfinance structures, it was observed by the Task Force that individual thrift per month generally does not exceed ₹50 and an MFI operating in a small geographical area and serving about 1,000 clients would require about five years to mobilize a level of aggregate savings of about ₹25 lakh. The Task Force, therefore, considers that cut-off level of business for the purpose of regulation and supervision by a regional or a national authority may be savings from the clients of the MFI and fixed at aggregate saving of ₹25 lakh.

MFIs Purveying Credit Only: The Task Force is of the view that for NGO-MFIs undertaking lending operations through a combination of their own resources, grants, and loan taken for on lending need not be governed by any elaborate regulation for the MFIs purveying credit only and not mobilizing savings in any manner. Once initial registration is done, the agencies may furnish only periodic statements. MFIs having borrowing from banks, development financial institutions or other agencies will be monitored by the lending agencies as part of their ordinary business as lenders. Such MFIs will have to comply with suitable prudential accounting norms relating to income recognition, asset classification and provisioning. Further, auditors may be required also to check the microfinance activities and they may be required to submit a special report confirming that the agency has got registered with the competent authority or has applied for that, and is not actually mobilizing any savings.

MFIs Mobilizing Savings and Purveying Credit: On observing that small saving service to the poor (almost at their own doorstep) is one of the essential financial services, the Task Force is of the view that NGOs may be treated as corporate for the limited purpose of Sec. 45 S of the RBI Act and may be allowed to mobilize savings only from their clientele as part of the financial services provided to them. After treated as corporate body, all MFIs under this category will have to register themselves with the appropriate registration authority. If such institution mobilizes savings in **excess of the cut-off limit**, they may have to register also with the central authority at national level. Those NGO-MFIs mobilizing **savings not exceeding ₹2 lakh** at any point of time may be excluded from the regulatory norms. However, such NGO-MFIs will have to obtain registration and submit periodic information to the competent authority. For those MFIs mobilizing saving above ₹2 lakh and **below cut-off level**, the regulation may comprise a minimum reserve of 10% of the savings at the end of the second preceding quarter. The MFIs may be asked to maintain the reserve in the form of deposits with any scheduled bank in any manner and forward specified quarterly statements to the registration authority. In respect of the MFIs having savings **above the cut-off level**, the reserve requirements may be 15 % of the savings to be maintained in the form of bank deposits. Further, these MFIs may be required to comply with prudential norms regarding income recognition, asset classification and provisioning. In respect of the NGO-MFIs mobilizing **savings or deposits from people other than clients** (including those under social sector interventions), the RBI will have to take a view.

4.2.2 MFIs and Policy Framework[21]

Various initiatives are taken to develop the policy framework for MFI, over a period of time. Following para discusses the same.

Capital Requirements: NGO-MFIs, non-profit companies MFIs, and mutual benefit MFIs are regulated by the specific Act under which they are registered and not by the Reserve Bank of India. These are, therefore, not subjected to minimum capital requirements, prudential norms, etc. NGO MFIs to become NBFCs are required to have a minimum entry capital requirement of ₹20 million. As regards prudential norms, NBFCs are required to achieve capital adequacy of 15% (w e f March 31, 2012) and maintain liquid assets of 15% on public deposits.

Foreign Investment: Foreign investment by way of equity is permitted in NBFC MFIs subject to a minimum investment of $500,000. In view of the minimum level of investment, only a few NBFCs are reported to have been able to raise the foreign investment. However, a large number of NGOs operating in the development/empowerment of poor are receiving foreign fund by way of grants.

Deposit Mobilization: Not for profit MFIs are barred, by the Reserve Bank of India, from mobilizing any type of savings. Mutual benefit MFIs can accept savings from their members. Only those NBFCs holding a valid Certificate of Registration with authorization to accept Public Deposits can accept/hold public deposits. NBFCs authorized to accept/hold public deposits besides having minimum stipulated Net Owned Fund (NOF) should also comply with the directions such as investing part of the funds in liquid assets, maintain reserves, rating etc. issued by the Bank.

Borrowings: Initially, bulk of the funds required by MFIs for on lending to their clients were met by apex institutions like National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), and Rashtriya Mahila Kosh (RMK). In order to widen the range of lending institutions to MFIs, the Reserve Bank of India has roped in Commercial Banks and Regional Rural Banks to extend credit facilities to MFIs since February 2000. Both public and private banks in the commercial sector have extended sizeable loans to MFIs at varying interest rates. Banks have been given operational freedom to prescribe their own lending norms keeping in view the ground realities. The intention is to augment flow of micro credit through the conduit of MFIs. In regard to external commercial borrowings (ECBs) by MFIs, not-for-profit MFIs are not permitted to raise ECB. The current policy effective from 31 January 2004, allows only corporate registered under the Companies Act to access ECB for permitted end use in order to enable them to become globally competitive players.

Interest Rates: The interest rates are deregulated not only for private MFIs but also for formal baking sector. In the context of softening of interest rates in the formal banking sector, the comparatively higher interest rates charged by the MFIs have become a controversial issue. The high interest rate collected by the MFIs from their poor clients is perceived as exploitative. It is argued that raising interest rates too high could undermine the social and economic impact on poor clients. Due to door step delivery of services to clients, transaction costs of MFIs are higher than that of the formal banking channels. Thus, the high cost structure of MFIs would affect their sustainability in the long run.

Collateral requirements: All the legal forms of MFIs have the freedom to waive physical collateral requirements from their clients. The credit policy guidelines of the RBI allow even the formal banks not to insist on any type of Security/margin requirement for loans upto ₹1,00,000 for Agriculture loans.

4.3 Major Recommendations from RBI[23, 24]

A High-level meeting on Micro finance was held under the Chairmanship of Deputy Governor Shri Vepa Kamesam on August 6, 2003 which was attended by senior executives of select Public sector and Private sector banks, Regional Rural Banks (RRBs), District Central Co-operative Banks (DCCBs), Microfinance institutions (MFIs), SIDBI and NABARD. Major recommendations given by the committee on issues related to: (i) Structure and Sustainability; (ii) Funding; (iii) Regulations; and (iv) Capacity Building.

(i) *Structure and Sustainability Issues*

1. Grant funding may be discouraged for purposes other than those defined as capacity building.
2. Interest rates on small loans from commercial banks to individuals may be de-regulated; specifically there must be total deregulation of interest rates on small loans (< ₹200,000) from commercial banks directly to individuals.
3. Banks may be allowed to partner with other agencies to offer 'third party banking' (like MFIs collecting deposits on behalf of banks), which will increase outreach without additional investments and permit flexibility in terms of location and service timings.

(ii) *Funding Issues*

1. An autonomous and professionally-managed National Micro Finance Equity Fund may be set up with an initial subscription of ₹200 crores (to be raised to ₹500 crores over 2-3 years) with contribution by banks which may be treated as Weaker Section lending under Priority Sector.
2. RBI should evolve special credit rating tools for MFIs in India and build up an MFI Information Bureau for providing information.
3. Commercial banks/RRBs may provide 10% of their loans to MFIs as grants for capacity building and these grants should be reimbursed by NABARD from Micro Finance Development Fund.

4. All NBFC-MFIs registered with RBI may be allowed to raise deposits subject to their obtaining minimum credit rating under the special credit rating tools developed for the MFI sector, Non-Banking Finance Companies (NBFC) or registered with RBI.
5. A separate category of NBFCs be created for attending to microfinance business with entry capital requirement of ₹25 lakhs
6. The amount of deposits mobilized by any such MFI should not exceed ₹5000/- per depositor and all such deposits may be covered by the guarantee of Deposit Insurance & Credit Guarantee Corporation (DICGC).

(iii) *Regulatory Issues*

- **For SHGs**
  1. SHGs may not lend outside the Group.
  2. SHGs may decide on some cap on borrowings per Member.
  3. Group to decide on apportioning of income earned during a year.
  4. Pass Books may be issued to each SHG Member.
  5. A rating matrix by lender to assess SHGs while making credit decisions to be made mandatory. The rating exercise to be done by the lender (NGO/MFI/bank) on a yearly basis to ensure no slippage in the ratings.
- **For NGOs**
  1. Those NGOs who opt to transform into Section 25 companies to repay the deposits and come out of the deposit portfolio.
  2. Broad guidelines for a rating matrix for NGOs are devised. Each lender to evolve its own rating matrix based on these guidelines. Rating exercise to be repeated annually to avoid slippage in rating. Rating to be done by accredited agencies in case of NGOs with borrowings of above ₹2 crores.
- **For Micro Credit Institutions (MCIs)**
  1. Company Law Board to allow SHGs to be members of Section 25 companies.
  2. There will be no ceiling in respect of loan amount extended by Section 25 companies to SHGs; however SHGs, to provide credit not exceeding ₹50,000/- per member of the SHG. RBI may consider issuing revised instructions. For fixation of interest, costs of capacity building, cost of management/ administration, cost of funds, rate of inflation and loan loss, were permitted to cover up.
  3. To encourage more flow of donations/contributions, donors to be exempted from income tax under Section 11C of the IT Act.

4. All income and interest on loans to be recognized on an accrual basis.
5. MFIs may build up loan loss reserves (2% of total assets to begin with and upto 10% over a period of 10 years); suitable exemption to be provided under IT Act for creation of loan loss reserves.
6. Legal status of institution with details of borrowings is disclosed. Details of borrowings, details of loans and classification of loans and method of deferring and amortization to be disclosed.
7. Institute of Chartered Accountants of India be involved in developing an effective audit mechanism.
8. Savings of SHGs promoted by Section 25 companies be maintained with permitted organizations.
9. Complete income tax exemption for Section 25 companies purveying micro credit (to the donor and to the receiver). Government to consider complete exemption from IT for income earned, as the main purpose of the organization is to empower the poor.

- **For Microfinance Institutions (MFIs - NBFCs)**
  1. Minimum entry-level capital requirement for micro finance NBFCs which is involved exclusively in financing SHGs be reduced to ₹25 lakhs from ₹200 lakhs at present. However, such NBFCs may not be allowed to accept deposits until their capital is raised to ₹200 lakhs.
  2. Capital adequacy norms should be more stringent compared to formal financial Institutions as all the loans provided by MFIs are collateral free loans. A minimum capital adequacy ratio of 10 % of the risk weighted assets is suggested.
  3. All income and interest on loans should be recognized on accrual basis. All accounts where interest/instalment is overdue for more than 45 days (to be moved to 30 days norm by 2007) to be treated as NPAs.
  4. The organization should provide adequate provisioning to take care of loan losses; to begin with it should be 2% on the standard assets. Exemption to be provided under IT Act for the loan loss reserves created. These guidelines to be more stringent when compared to formal institutions as all the loans provided by NBFCs are collateral free loans.

Based on the recommendations of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Vyas Committee), in the Annual Policy Statement for the year 2004-05, it has been announced that, in view of the need to protect the interest of depositors, MFIs would not be permitted to accept public deposits unless they comply with the extant regulatory of the Reserve Bank.

(iv) *Capacity Building Issues*

1. Each bank could establish an exclusive micro finance cell to design strategies of the bank and creating an enabling environment to develop microfinance as core business of poverty lending.
2. RBI shall facilitate setting up of business incubation fund through SGSY (Swarnjayanti Gram Swarozgar Yojana) programme for providing venture capital support.
3. SHGs may be networked into community-based organization at cluster/federation level.
4. Rural Infrastructure Development Fund (RIDF) funds may also be used for SHG promotion.
5. An innovation fund for research and development may be initiated.
6. Common performance standards based on key financial and non-financial indicators may be involved.
7. Microfinance resource centres with exclusive focus on capacity building may be set up in five different regions.

4.4 Limitations of Legal Regulatory Framework

India has a large number of MFIs varying significantly in size, outreach and credit delivery methodologies. Presently, there is no regulatory mechanism in place for MFIs except for those which are registered as NBFCs with RBI. However, all NBFCs are currently regulated by Reserve Bank of India under Chapters III-B, III-C and V of the Reserve Bank of India Act. There is no separate category created for NBFCs operating in the Microfinance sector. As a result, MFIs are not required to follow standard rule and it has allowed many MFIs to be innovative in its approach, particularly, in designing new products and processes. But the flip side is that the management and governance of MFIs generally remains weak, as there is no compulsion to adopt widely accepted systems, procedures and standards. Because the sector is unregulated, not much is known about their internal health.[21]

The Association of Community Development Finance Institutions argues that an overtly commercial approach, albeit with sufficient regulation is institutionally more sustainable. This approach to microfinance in India 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. The key factor is that the RBI regulates only those microfinance institutions which are registered with it as NBFCs. Further, there is a regulatory gap between the way the RBI regulates NBFCs and normal banks. Although the registered companies cover over 80 per cent of the microfinance business, in terms of number of companies they constitute a small percentage of the total number of MFIs in the country. The RBI, however, does not prescribe lending rates for these institutions. A skepticism that exists is that registering as not-for-profit companies under Section 25 of the Companies Act 1956, is to take advantage of the RBI's exemption from registration for such companies providing microfinance services.[25]

Additional limitation is the implementation of new RBI requirements regarding priority sector lending, particularly with regard to borrower income and borrower indebtedness. Since there are no tax-filings or credit reports for the majority of microfinance customers, the income related information is mostly reported by the customer. Thus, customers have an incentive to misrepresent their income and indebtedness in order to qualify for a loan. Without a functioning credit bureau, these customer characteristic requirements are impossible to accurately enforce. Another limitation is the universal margin and interest rate cap, which could be detrimental for the sector, since it would most likely result in the reduction of financial services in various areas and populations where returns would not justify the operating cost. Lack of diversification of funding sources is also problematic for MFIs due to the current regulation regarding access of capital.[26]

4.5 Summary

Table 4.2 is summing up the details of existing legal framework for the financial institutions engaged directly or indirectly in providing microfinance facilities.

Table 4.2
Summary of Legal Framework for Institutions Engaging Directly or Indirectly in Microfinance

Category of Institutions	Type of Institutions	Legal Framework: Licensing	Action Allowed	Action Not Allowed	Minimum Capital Require-ment
Banks	Scheduled Commercial Banks	Reserve Bank of India Act	Fully Banking services, enumerated in Section 6.	Must respect priority sector lending target (40% bank credit) of which 25% to weaker sections: local area banks may operate only in designated areas	₹100 crores

Table 4.2 Contd.

Category of Institutions	Type of Institutions	Legal Framework: Licensing	Action Allowed	Action Not Allowed	Minimum Capital Requirement
Commercial MFIs	Regional Rural Banks (RRBs)	Regional Rural Banks Act of 1970	Opening A/c, saving, lending only in rural areas	*	*
	Non Banking Finance Companies (NBFCs)	Section 45-I(f) of RBI Act NBFC rules (some registered , some not)	Only time deposits with one time maturity	Under covenants in the RBI Act, no public savings unless a satisfactory (A) rating is received; maximum allowed is 4 times net owned funds for AAA rated companies; No current, recurring or savings deposits	₹2 crores
	Local Area Banks (LABs)	Banking Regulation Act of 1949	Deposit mobilization is allowed (current, recurring, savings and time deposits). No upper limit, although in practice maximum is 10 to 12 times net owned funds	*	₹5 crores
Mutual Benefit MFIs	Urban Cooperative Banks	State of Multi-State Cooperative Societies Act	Deposits allowed with an upper limit on deposits; Can take current, recurring, savings and time deposits	*	₹50 lakhs
	Mutually Aided Cooperative Societies (MACSs)	Incorporated under AP MACS Act; RBI licenses under Banking Reg. Act and Cooperative Societies Rules of 1966	Funds from members in the form of share capital, deposits, debentures, loans and other contribution; Public savings as allowed in bye-laws	Raising share capital from government	None

Table 4.2 Contd.

Category of Institutions	Type of Institutions	Legal Framework: Licensing	Action Allowed	Action Not Allowed	Minimum Capital Requirement
Non-Profit MFIs	Section 25 Companies	Companies Act 1956	Can take current, recurring, savings and time deposits.	*	None
	NGOs	No licensing (registration under the Societies Act or Indian Trusts Act)	Lending is not allowed under these acts, but is considered on the basis of the inclusion of lending in statutes submitted as part of the registration process under these Acts	Deposit collection technically not allowed, limited by covenants under the RBI Act	None

Source: Singh H. R. & Singh N. D. (2011)[27] * = Data not mentioned in the source.

After discussing the existing legal regulatory framework for MFIs in this chapter, following chapter is going to present the details about the working methods of MFIs. It also provides the comparative analysis about the MFIs working in different states of India.

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