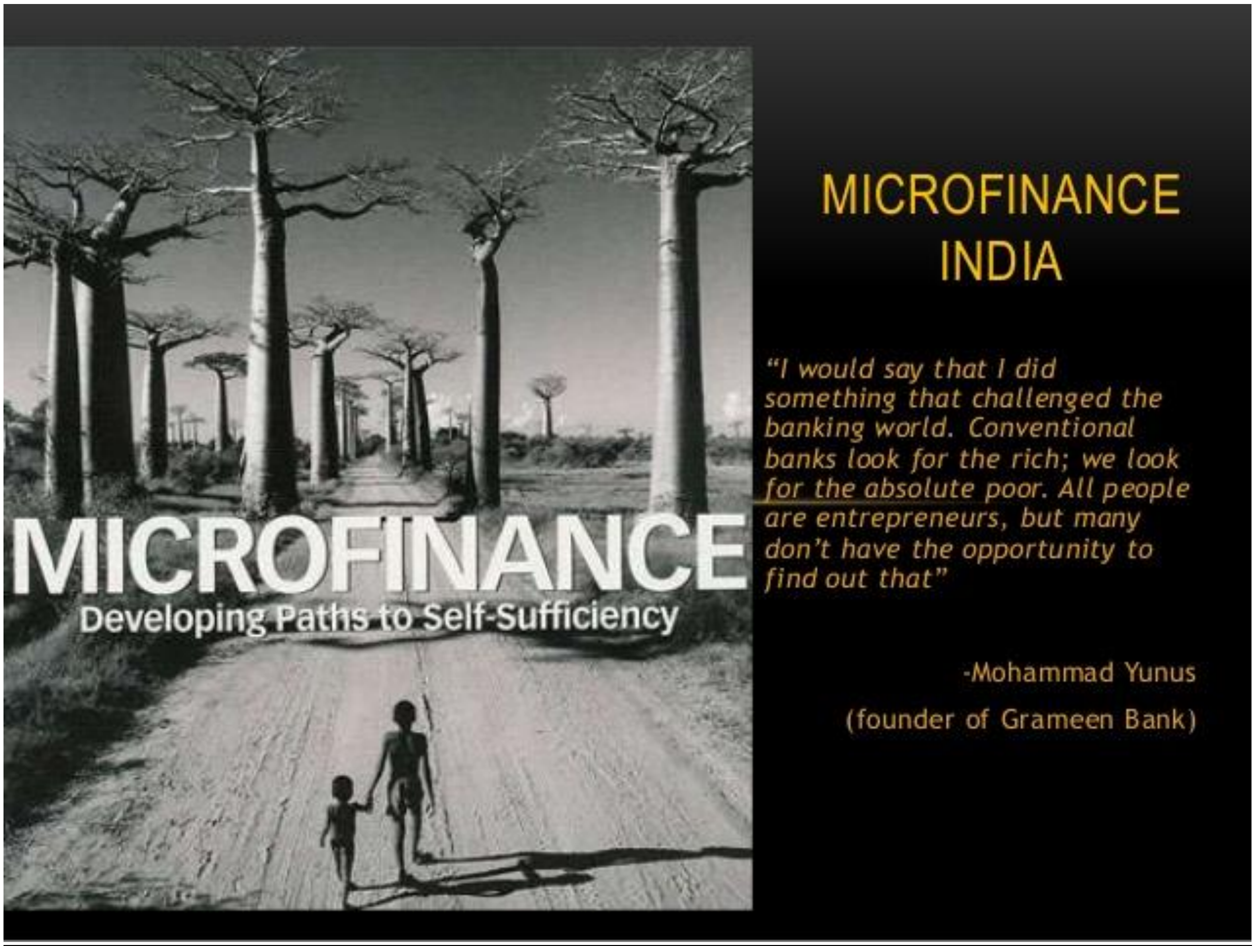
HANDBOOK ON MICROFINANCE INSTITUTIONS

INDEX

CHAPTER: 1 BIRTH OF MICROFINANCE



1.1 HISTORY

Money is required for every single step of Business Life-Cycle, Micro Finance is about the finance to satisfy the need for small entrepreneurs to fulfill or to set up a business at a small scale and give a source of livelihood to people from poor villages, and increase the standard to live life in an optimistic manner.

Franciscan monks founded the community-oriented pawnshops in the 15th century, The history of microfinancing can be traced back as far as the middle of the 1800s, when the theorist Lysander Spooner was writing about the benefits of small credits to entrepreneurs and farmers as a way of getting the people out of poverty The founders of the European credit union movement in the 19th century(Spooner, Friedrich Wilhelm Raiffeisen) founded the first cooperative lending banks to support farmers in rural Germany.

The birth of "modern micro-finance" is said to have occurred in the mid 1970s in rural Bangladesh when the founders of the "microcredit" movement in the 1970s as Dr. Muhammad Yunus (professor of economics at the University of Chittagong) and Al Whittaker, have tested practices and built institutions designed to bring the kinds of opportunities and risk-management tools that financial services can provide to the doorsteps of poor people. While the success of the Grameen Bank, which serves over 7 million poor Bangladeshi women has inspired the world. In nations with lower population densities, meeting the operating costs of a retail branch by serving nearby customers has proven considerably more challenging. To find a practical solution, Dr. Muhammad Yunus began visiting local villages. In one nearby village, Jorba, he found a group of 42 women who made bamboo stools. Because they lacked the funds to purchase the raw materials themselves, they were tied into a cycle of debt with local traders, who would lend them the money for the materials on the agreement that they would sell the stools at a price barely higher than the raw materials. Yunus was shocked to find that the entire borrowing needs of the 42 women amounted to the equivalent of US$27. He lent them the money from his own pocket at zero interest, enabling the women to sell their stools for a reasonable price and break out of the cycle of debt. Another pioneer in this sector is Akhtar Hameed Khan

Inspired by the success of The Grameen Bank, the 1970s and 80s saw rapid growth in the number of new micro-finance institutions appearing around the world, many of them started by NGOs and funded by grants and subsidies from public and private sources. They demonstrated that the poor could be relied on to repay their loans, even without collateral, and hence that micro-finance was a potentially viable business.

During the 1990s, the industry began to realize that it could not continue to grow at such rates while still relying on grant funding. As a result, many began to restructure themselves to attract commercial investors, adopting more formal business practices and working to improve their efficiency and sustainability.

1998 saw the formation of PlaNet Finance, a not-for-profit organization whose initial objective was to use the internet and new communication technologies to reinforce the capacities of NGOs in various sectors. This soon evolved into the PlaNet Finance; which is know today as an international NGO whose mission is to fight against poverty by developing micro-finance

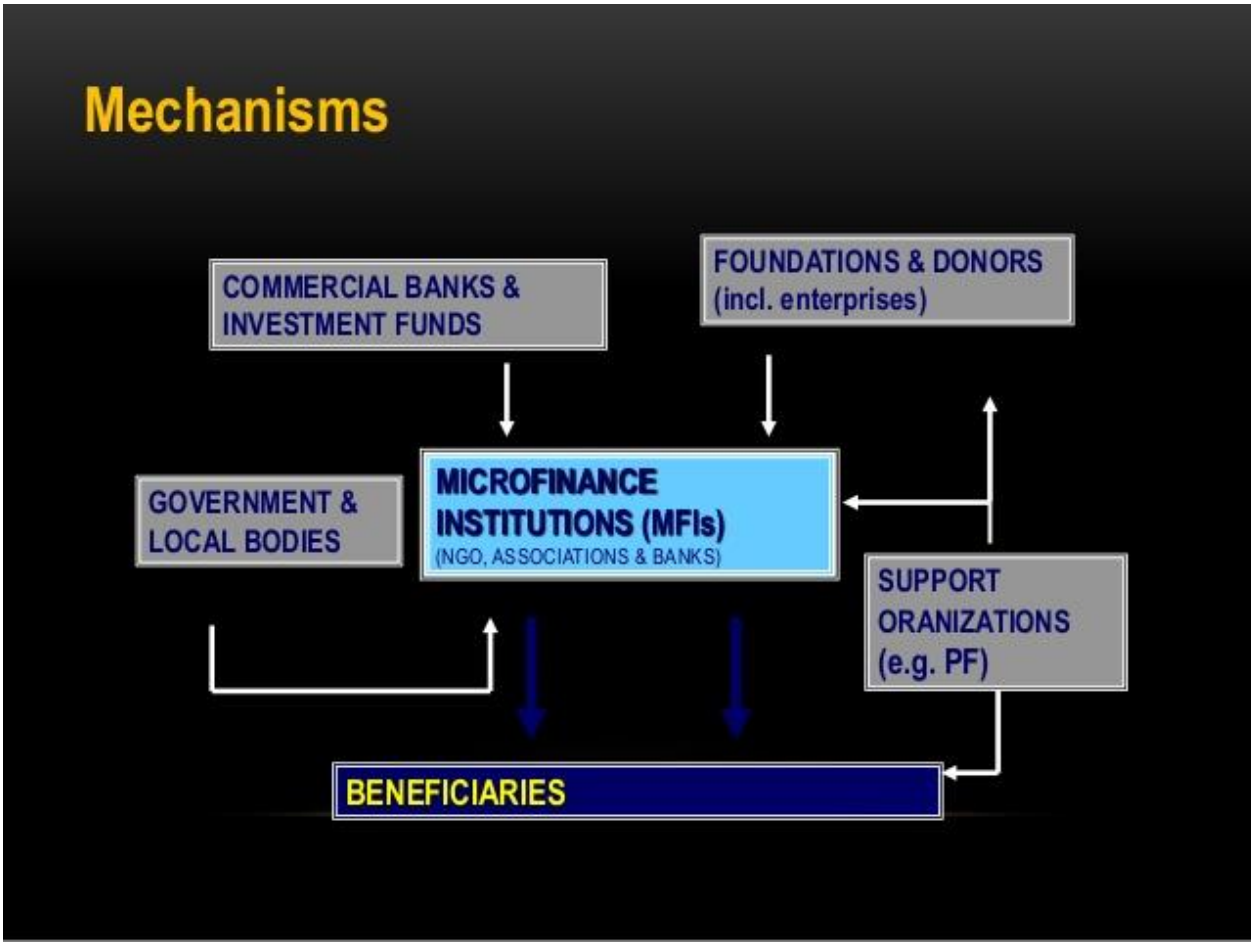
The Grameen Bank project, translated as “Village Bank”, was born, and today works in over eighty-thousand villages with more than six million borrowers. In 2006 both Yunus and Grameen were awarded the Nobel Peace Prize for their work with the poor.

1.2 What is Microfinance?

DEFINITION

The term “micro-finance” has been given a working definition by the Task Force on Supportive Policy and Regulatory Framework for Micro-Finance 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”.**

Microfinance is a source of financial services for entrepreneurs and small businesses lacking access to banking and related services. The two main **mechanisms** for the delivery of financial services to such clients are: (1) relationship-based banking for individual entrepreneurs and small businesses; and (2) group-based models, where several entrepreneurs come together to apply for loans and other services as a group.



Microfinance is a broad category of services, which includes microcredit. Microcredit is provision of credit services to poor clients. Microcredit is one of the aspects of microfinance and the two are often confused. Critics may attack microcredit while referring to it indiscriminately as either 'microcredit' or 'microfinance'. Due to the broad range of microfinance services, it is difficult to assess impact, and very few studies have tried to assess its full impact. Proponents often claim that microfinance lifts people out of poverty, but the evidence is mixed. What it does do, however, is to enhance financial inclusion.

Microfinance refers to a variety of financial services that target low income clients, particularly women. Since the clients of microfinance institutions (MFIs) have lower incomes and often have limited access to other financial services, microfinance products tend to be for smaller monetary amounts than traditional financial services. These services include loans, savings, insurance, and remittances. Microloans are given for a variety of purposes, frequently for microenterprise development. The diversity of products and services offered reflects the fact that the financial needs of individuals, households, and enterprises can change significantly over time, especially for those who live in poverty. Because of these varied needs, and because of the industry's focus on the poor, microfinance institutions often use non-traditional methodologies, such as group lending or other forms of collateral not employed by the formal financial sector.

“Microfinance” is often defined as financial services for poor and low-income clients offered by different types of service providers. In practice, the term is often used more narrowly to refer to loans and other services from providers that identify themselves as “microfinance institutions” (MFIs). These institutions commonly tend to use new methods developed over the last 30 years to deliver very small loans to unsalaried borrowers, taking little or no collateral. These methods include group lending and liability, pre loan savings requirements, gradually increasing loan sizes, and an implicit guarantee of ready access to future loans if present loans are repaid fully and promptly.

More broadly, microfinance refers to a movement that envisions a world in which low-income households have permanent access to a range of high quality and affordable financial services offered by a range of retail providers to finance income-producing activities, build assets, stabilize consumption, and protect against risks. These services include savings, credit, insurance, remittances, and payments, and others.

The term "microfinance," once associated almost exclusively with small-value loans to the poor, is now increasingly used to refer to a broad array of products (including payments, savings, and insurance) tailored to meet the particular needs of low-income individuals. People living in poverty, like everyone else, need a diverse range of financial services to run their businesses, build assets, smooth consumption, and manage risks.

1.3. How does microfinance help the poor?

The impact of microcredit has been studied more than the impact of other forms of microfinance. Microcredit can provide a range of benefits that poor households highly value including long-term increases in income and consumption. A harsh aspect of poverty is that income is often irregular and undependable. Access to credit helps the poor to smooth cash flows and avoid periods where access to food, clothing, shelter, or education is lost. Credit can make it easier to manage shocks like sickness of a wage earner, theft, or natural disasters. The poor use credit to build assets such as buying land, which gives them future security. Women participants in microcredit programs often experience important self-empowerment.

CHAPTER 2: GLOBAL IDEA OF MICROFINANCE

Microfinance institutions currently operate in over 100 countries, serving more than 92 million clients. Micro finance developed from banking systems dating back to the early 1700 when Jonathan Swift, an Irishmen, had the vision of creating a banking system that would reach the poor. He created the Irish Loan Fund, which gave small short term loans to the poorest people in Ireland who were not being served by commercial banks, in hopes of creating wealth in the rural areas of Ireland. This idea took years to catch on, but then grew quickly and expanded globally. By the 1800‟s, the Irish Loan Fund had over 300 banks for the poor and was serving over 20% of the Irish population.

In the 1800s similar banking systems showed up all across Europe targeting the rural and urban poor. Friedrich Wilhelm Raiffeisen of Germany realized that the poor farmers were being taken advantage of by loan sharks. He acknowledged that under the current lending system, the poor would never be able to create wealth; they would be stuck in a cycle of borrowing and repaying without ever making personal economic development. He founded the first rural credit union in 1864 to break this trend. This system was different than previous banks because it was owned by its members, provided reasonable lending rates and was created to be a sustainable means of community economic development. The idea of credit unions spread globally and by the end of the 1800s, these micro credit systems had spread all the way from Ireland to Indonesia. At the turn of the century similar systems were opening in Latin America. Whereas in Europe the credit unions were owned by its members, in Latin America the institutions were owned by the government or private banks and were not as efficient as they were in Europe. In the 1950‟s donors and government subsidies were used to fund loans primarily for agricultural workers to stimulate economic growth but these efforts were short lived. The loans were not reaching the poorest farmers; they were often ending up in the hands of the farmers who were better off and didn‟t need the loans as critically as others. Funds were being lent out with an interest rate much below the market rate and there were not enough funds to make this viable long term. These loans were rarely being repaid, so the banks‟ capital was depleting quickly and when the subsidized funds ran out, there was no more money to pump into the agricultural economy in the form of micro credit banks are increasingly becoming commercialized.

The first commercial microfinance institution was founded in Bolivia in 1992. The founders of this commercial MFI were originally the founders of a nonprofit MFI in 1986 called PRODEM. PRODEM grew so rapidly that after 2 years, it had more people desiring loans than they could support. They then created BancoSol to meet the growing needs of the borrowers in Bolivia and became the first ever MFI to issue dividends. Nonprofit micro finance institutions are successful, but reach a capacity of lending when they run out of donations.

As enthusiasm for micro-finance as a tool for poverty alleviation increased, focus moved away from NGO models towards promoting a sustainable industry that could provide financial services to the poor at fair prices while offering a reasonable return to commercial investors. As well as the many micro-finance investment firms that exist today, several large banking institutions have also entered the industry, such as Credit Suisse, Deutsche Bank and Citigroup.

By the end of 2008, nearly $15 billion of foreign investment had been channelled into micro-finance institutions, the majority still from government development organizations such as the

World Bank, but with large amounts arriving from a variety of private and commercial sources. There are currently over 10,000 micro finance institutions serving 16 million people.

MFIs are nowadays classified into three categories of commercial, quasi-commercial and nonprofit micro finance institutions. Each category has its own distinctive characteristics and focuses on serving its target population differently.

The future of micro-finance is hard to forecast, but several estimates suggest that 500 million to 1.5 billion people still lack access to financial services that could strengthen their economic situation and improve their life conditions.

The role of micro-finance and other alternatives ways to encourage and assist auto-entrepreneurship are likely to remain important in the global economy

CHAPTER 3: MICROFINANCE SECTOR IN INDIA

The Indian microfinance sector witnessed tremendous growth over the last five years, during which institutions were subject to little regulation. Some microfinance institutions were subject to prudential requirements; however no regulation addressed lending practices, pricing, or operations. The combination of minimal regulation and rapid sector growth led to an environment where customers were increasingly dissatisfied with microfinance services, culminating in the Andhra Pradesh crisis in the fall of 2010. Leading up to the Andhra Pradesh crisis, microfinance institutions were experiencing a large influx of equity and debt investment.

Due to low repayment rates, microfinance institutions, with exposure to Andhra Pradesh, suffered significant losses. Banks stopped lending to microfinance institutions all over India, for fear that a similar situation would occur elsewhere, resulting in a liquidity crunch for microfinance institutions, which are largely dependent on bank lending as a funding source. With the sector at a standstill, microfinance institutions, microfinance clients, banks, investors, and local governments were calling for new regulation to address the prominent issues of the sector.

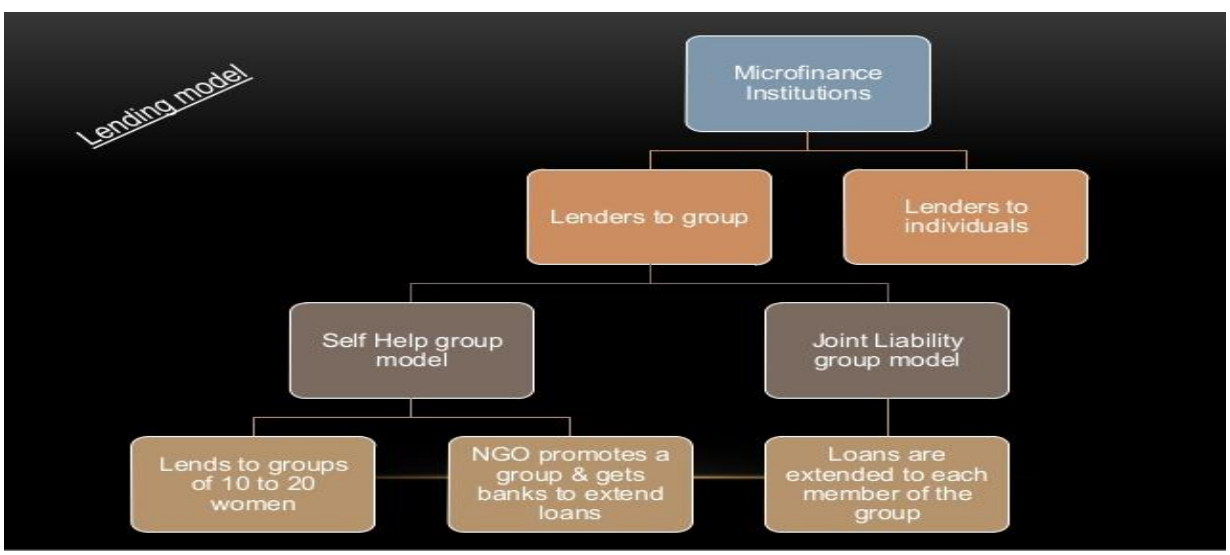
The Reserve Bank of India (RBI) responded by appointing an RBI sub-committee known as the Malegam Committee. This committee aimed to address the primary customer complaints that led to the crisis, including coercive collection practices, usurious interest rates, and selling practices that resulted in over-indebtedness The Malegam Committee released their recommended regulations in January 2011.

According to the latest research done by the World Bank, India is home to almost one third of the world's poor (surviving on an equivalent of one dollar a day). Though many central government and state government poverty alleviation programs are currently active in India, microfinance plays a major contributor to financial inclusion. In the past few decades it has helped out remarkably in eradicating poverty.

About half of the Indian population still doesn't have a savings bank account and they are deprived of all banking services. Poor also need financial services to fulfill their needs like consumption, building of assets and protection against risk. Microfinance institutions serve as a supplement to banks and in some sense a better one too. These institutions not only offer micro credit but they also provide other financial services like savings, insurance, remittance and non-financial services like individual counseling, training and support to start own business and the most importantly in a convenient way. The borrower receives all these services at her/his door step and in most cases with a repayment schedule of borrower's convenience. But all this comes at a cost and the interest rates charged by these institutions are higher than commercial banks and vary widely from 10 to 30 percent. Some claim that the interest rates charged by some of these institutions are very high while others feel that considering the cost of capital and the cost incurred in giving the service, the high interest rates are justified.

MFI FACT SHEET
* Size of MFI industry in India: Approximately Rs 30,000 crore
* Size of AP market: Over Rs 10,000 crore
* MFIs portfolio in AP: Around Rs 6,000 crore.
* Outstanding loans in AP by MFIs: About Rs 6,000 crore.
* Banks exposure to MFIs in AP: Rs 5,000 crore
* Banks exposure to MFI industry: Rs 18,000 crore
* Number of MFI borrowers in AP: About 8 million
* New MFI borrowers in AP (Oct 2010-present): None
* Default rate before Act: About 2%
* Default rate post Act: 85- 90%.
* No. of job-cuts in AP if MFIs shut shop: 25,000 (rural youth, not highly qualified)
* Write-offs (from Oct-present):Rs 2,500-3,000 crore

LENDING MODEL



3.1 Major and relatively recent developments in the microfinance sector

1. **External Commercial Borrowings**

   The RBI has permitted specified Micro Finance Institutions (MFIs) to avail external commercial borrowings (ECB) upto USD 10 million per financial year under the automatic route for lending to self-help groups or for micro-credit or for bonafide micro finance activity including capacity building. The limit to avail ECB for Non-Government Organisations (NGOs) engaged in micro finance activities has also been increased up to USD 10 million per financial year. All other ECB parameters such as minimum average maturity, all-in-cost ceilings, etc. would need to be complied with.

2. **Social Venture Capital Funds**

   Not only are the new private sector banks and the foreign banks competing with each other to fund microfinance institutions (MFIs), but now MFIs may have access to equity social venture capital funds, which had been surveying and accessing the Indian market till recently, and have now started investing.

3. **Partnership Model**

   The partnership model of financing MFIs, based on an analysis of traditional financing models and ICICI Bank's experience in India. The bank, therefore, pioneered a partnership model that attempted to separate MFI risk from portfolio risk, provide a mechanism for banks to incentivize partner MFIs and deal with the inability of MFIs to provide risk capital in large amounts. The model has the following key characteristics: a) Loan contracts directly between bank and borrower; b) Alignment of incentives with a first-loss guarantee structure, c) Transfer of implicit capital from the bank to the MFI through an overdraft facility.

   The partnership model may prove critical in unleashing wholesale funds of Indian banks. It combines debt and mezzanine finance, enabling the MFI to increase outreach rapidly, while unlocking large amounts of wholesale funds available in the commercial banking sector in India.

3.2 Banking Correspondent Model and Banking Facilitator

i. Bank Partnership Model

I. *MFI as Agent*

In this model, the MFI acts as an agent and it take Care of all relationships with borrower from first contact to final repayment.

II. *MFI as holder of Loans*

Here MFI holds the individual loans on its books for a while, before securitizing them and selling them to bank.

ii. Banking Facilitators

Banking facilitators / correspondents are intermediaries who carry out banking functions in villages or areas where it is not possible to open a branch. In January, 2006, RBI permitted banks to use services of NGOs, MFIs and other civil society organizations to act as intermediaries in providing financial and banking services to poor.

3.3 Micro Finance Institutions (Development and Regulations) Bill 2011

The Malegam Committee released their recommended regulations in January 2011. These recommendations were 'broadly accepted' by RBI in May 2011, though specific regulation was only released regarding which institutions qualify for priority sector lending at this time. Additionally, an updated version of the Micro Finance Institutions (Development and Regulations) Bill 2011 is in Parliament, which aims to provide a regulatory structure for microfinance institutions operating as societies, trusts, and cooperatives.

CHAPTER 4: LEGAL FRAMEWORK

Legal Framework of Microfinance prepares the base for Micro Financial Institutions. Microfinance institution acquires permission to lend through registration. Each legal structure has different formation requirements and privileges. Microfinance institutions in India are registered as one of the following **FIVE ENTITIES**:

- ***Non Government Organizations engaged in microfinance (NGO-MFIs), comprised of Societies and Trusts***
- ***Cooperatives registered under the conventional state-level cooperative acts, the national level multi-state cooperative legislation Act (MSCA 2002), or under the new state-level mutually aided cooperative acts (MACS Act)***
- ***Section 25 Companies (not-for-profit)*** (Ref. Section 8 under Companies Act 2013)
- ***For-profit Non-Banking Financial Companies (NBFCs)***
- ***NBFC-MFIs***

There are several legal forms of MFIs. However, firm data regarding the number of MFIs operating under different forms is not available. It is roughly estimated that there are about 1,000 NGO-MFIs and more than 20 Company MFIs. Further, in Andhra Pradesh, nearly 30,000 cooperative organizations are engaged in MF activities. However, the company MFIs is major players accounting for over 80% of the microfinance loan por

SR.NO	Type of Entity	CATEGORY		
		Non-profit	**For-profit**	**Mutual Benefit**
1.	**Association**	Society under Societies Registration Act 1860	Association of persons	Cooperatives registered under the conventional state-level cooperative acts, the national level multi-state cooperative legislation Act (MSCA 2002), or under the new state-level mutually aided cooperative acts (MACS Act)
2.	**Trust under Indian Trust Act 1882**	Charitable trust.	Investment trusts	Mutual benefit trust
3.	**Companies under Companies Act 1956 and ref. of Companies Act 2013 and registered**	Company under Companies Act 1956	Company which is either an NBFC or a bank	Mutual Benefit (Sec 620A Nidhi Company under Companies Act 1956 (Ref.Section 406

	with RBI	(Ref.Section 8 under Companies Act 2013)		under Companies Act 2013)

BRIEF NOTE ON REGISTRATION OF MICRO FINANCIAL INSTITUTIONS

4.1 SOCIETIES REGISTRATION ACT, 1860

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, 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 recognizes 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."

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.

1 Registration of Society

The application for **registration of a society** (under the Societies Registration Act, 1860) should be made to the assistant registrar of having jurisdiction over the region / sub region in which the society is sought to be registered.
The application should be submitted together with
• memorandum of association and rules and regulations;
• consent letters of all the members of the managing committee;
• authority letter duly signed by all the members of the managing committee;
• an affidavit sworn by the president or secretary of the society on non-judicial stamp paper

of Rs 10/-, together with a court fee stamp and
• a declaration by the members of the managing committee that the funds of the society will be used only for the purpose of furthering the aims and objects of the society.
In Maharashtra state, since the registrar of societies is the charity commissioner, the society also has to be registered as a trust, hence an application should also be made u/s 18 of the Bombay Public Trusts Act 1950, in the prescribed form.
All the aforesaid documents which are required for the application for registration should be submitted in duplicate, together with a registration fee of Rs 50/-. Unlike the trust deed, the memorandum of association and rules and regulations need not be executed on stamp paper.
The process of registering a society generally takes a longer time than registering a trust.

Steps involved for forming a **Cooperative Society** are as under.
(i) Prescribed application duly filled in shall be made to the Registrar of Cooperative societies;
(ii) the application shall be accompanied by four copies of the proposed Bye-laws of the society;
(iii) Where all the applicants are individuals, the number of applicants shall not be less than ten;
iv) the application shall be signed by every one of such applicants if the applicants are individuals;
v) if the applicant is a society, by a member duly authorised by such society;

To form a **Multi-State Cooperative society**,
(i) An application for registration of a Multi-State Cooperative society shall be made in the prescribed
form;
(ii) the application shall be signed by;
(a) In the case of a multi-state Cooperative society of which all the members are individuals, by at least fifty persons from each of the states concerned.
(b) In case the members are Cooperative Societies, by duly authorized representatives on behalf of at least five such societies as are not registered in the same state;
(c) In case the members are other Multi-State Cooperative Societies and other Cooperative Societies, by duly authorized representatives of each of such societies;
(d) If the members are cooperative societies or multi-state Cooperative societies and individuals, by at least (i) fifty persons, being individuals from each of the two states or more and; (ii) one Cooperative society each from two states or more or one Multi-state Cooperative society.
(e) The application shall be accompanied by four copies of the proposed Bye-laws.
(f) (i) Name of the proposed multi-state cooperative society;
(ii) Head Quarters and address to be registered;
(iii) Area of operation;
(iv) Main objectives
(v) a certificate from the Bank
(vi) Stating credit balance there in favour of the proposed Multi-State Cooperative Society.

Mutually Aided Cooperative Society (MACS)

The dependence of co-operative societies on Government and the consequent rigors of regulation by Government on co-operative societies has led to the enactment of Mutually

Aided Co-operative Societies Act or Self Financing Co-operative Societies Act in several states. In the societies under the enactments, Government capital is prohibited and the management of the societies is vested in the Board of Directors and the policies are decided by the General Body subject to limited regulatory powers exercised by the Registrar by way of registration of society, registration of bye laws, etc. These State enactments are in addition to the existing State laws on co-operative societies and provides alternative legal framework for co-operative societies. As the MACS are treated as incorporated bodies under the Acts, they can carryout different types of transaction like mobilization of savings, disbursement of credit, and housing and insurance products.
There is no minimum share contribution stipulated for members. Registration of society requires minimum funds. MACS in AP are regulated by government departments as regards their regular functioning and they are required to submit their accounts to Registrar of Society.

2 <u>Investment of Funds of a Society by the Governing Body</u>

Financial nature of work of MFIs 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.

3 <u>Accounts & Audit</u>

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 -

I. 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.
II. 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.
III. 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.

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.

4 <u>Foreign Contributions</u>

Acceptance of foreign contribution by MFIs registered under the Societies Registration Act 1860 is regulated by the Foreign Contribution (Regulation) Act, 2010 (FCRA). This Act defines foreign contribution as donation, delivery or transfer made by any foreign source-

I. Of any article, not being an article given to a person as a gift for his personal use, if the market value, in India of such article, on the date of such gift, is not more than such sum as may be specified from time to time, by the Central Government by the rules made by it in this behalf;
II. Of any currency, whether Indian or foreign; and
III. of any security as defined in clause (h) of Section 2 of the Securities Contracts Regulation, Act 1956 and includes any foreign security as defined in clause (o) of Section 2 of the Foreign Exchange Management Act, 1999.

In order to access foreign contributions, MFIs need to make applications in the prescribed form 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.

5 <u>Dissolution</u>

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.

4.2 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.

1 <u>Formation of a Trust</u>

As per Section 6 of the Indian Trust Act 1882, the essential constituents of a trust are Three parties – the author, trustees and beneficiary;

i. Declaration of a trust;
ii. Certainty of the subject matter of a trust; and
iii. 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

2 REGISTRATION OF PUBLIC TRUST

The application for registration of a public charitable trust should be submitted (under section 18 of the Bombay Public Trusts Act, 1950) to the deputy/assistant charity commissioner having jurisdiction over the region / sub region in which the trust is sought to be registered.

After providing details regarding designation by which the public trust shall be known, names of trustees, mode of succession, etc., the applicant has to affix a court fee stamp of Rs. 2/- to the form and pay in cash, registration fee which may range from Rs 3/- to Rs 25/-, depending on the value of the trust property. If the value of the trust property does not exceed Rs 2,000/-, the registration fee levied is Rs 3/-. If the value exceeds Rs 25,000/- it is Rs 25/-. The application form should be signed by the applicant before the regional officer or superintendent of the regional office of the charity commissioner or a notary. The application form should be submitted, together with a copy of the trust deed which is the main instrument of the trust
The trust deed must be executed on non-judicial stamp paper, the value of which would depend on the valuation of the trust property.
If one decides to start a trust with a token amount of Rs. 1,000/-, the trust deed should be executed on a non-judicial stamp paper of Rs 40/-The trust deed should be signed by both the settlor/s and trustee/s in the presence of a witness. It is adivsible to sign before a notary.
Two other documents which should be submitted at the time of making an application for registration are

• affidavit which must be sworn (by the trustees making the application) before a notary and executed on non-judicial stamp paper of Rs 10/- and
• consent letter which may be prepared on a plain paper and signed by the trustee/s other than the trustee making the application. In the absence of a consent letter from the remaining trustees, the deputy/assistant charity commissioner can insist on the presence of all the remaining trustees for the hearing. A notice informing the applicant about the day and time fixed for a formal hearing is dispatched usually 10 to 15 days in advance. The applicant generally has to appear in person or depute his / her lawyer. The original trust deed should be produced for verification at the time of the hearing. After making enquiries on the aforesaid issues, the deputy / assistant charity commissioner makes entries in the register kept under section 17 (popularly known as schedule I) of the Bombay Public Trust Act and issues a certificate of registration which bears the official seal and registration number of the trust.

3 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

4 **Management of a Trust**

Trusts are managed by their trustees.
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.

5 **Accounts & Audit**

Trust must Maintain proper set of Books of Accounts, Management must have following policies,

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.

6 **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.

7 Compatibility with the insurance regulations

IRDA regulations do not recognize 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.

4.3. NOT-FOR-PROFIT COMPANIES REGISTERED UNDER SECTION 25 OF COMPANIES ACT, 1956 (Ref. Section 8 under Companies Act 2013)

Section 25 of the Companies Act 1956, (Ref. Section 8 under Companies Act 2013) allows a company to be registered 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. (Ref. Section 8 under Companies Act 2013)

1 Registration

A fresh entity and an association as well as an existing company are entitled to be registered as a Section 25 company (Ref. Section 8 under Companies Act 2013) provided they follow certain procedures and fulfill requirements.

Before forming a company it should be ascertained whether the name proposed is available for registration or not. An application in form no 1A is to be submitted by suggesting three alternative names if the first name applied is not available. An amount of Rs 500 as fee also to be paid at the time of submission of the form 1A.After ascertaining the availability of name separate application in writing to be made to the regional director of the company law board. Following documents are to be attached to the application.

• Three copies of the memorandum and articles of association of the proposed company, duly signed by all the promoters with full name, address and occupation.

• A declaration by an advocate or a chartered accountant that the memorandum and articles of association have been drawn up in conformity with the provisions of the Act and that all the requirements of the Act and the rules made thereunder have been duly complied with.

• Three copies of a list of the names, addresses and occupations of the promoters (and where a firm is a promoter, of each partner in the firm), as well as of the members of the proposed board of directors, together with the names of companies, associations and other institutions in which such promoters, partners and members of the proposed board of directors are directors or hold responsible positions, if any, with description of the positions so held.

A statement showing in detail the assets with the estimated values thereof and the liabilities of the association, as on the date of the application or within seven days of that date.

• An estimate of the future annual income and expenditure of the proposed company, specifying the sources of the income and the objects of the expenditure.

• A statement giving a brief description of the work, if any, already done by the association and of the work proposed to be done by it after registration, in pursuance of section 25. (Ref. Section 8 under Companies Act 2013)
• A statement specifying briefly the grounds on which the application is made.
• A declaration by each of the persons making the application that he / she is of sound mind, not an undischarged insolvent, not convicted by a court for any offence and does not stand disqualified under section 203 of the companies Act, 1956, for appointment as a director. The applicants must also furnish to the registrar of companies (of the state in which the registered office of the proposed company is to be, or is situate) a copy of the application and each of the other documents which had been filed before the regional director of the company law board. The applicants should also, within a week from the date of making the application to the regional director of the company law board, publish a notice in the prescribed manner at least in one newspaper in a principal language of the district in which the registered office of the proposed company is to be situated or is situated and circulating in that district, and at least in a English newspaper circulating in that district. The regional director shall, after considering the objections, if any, received within 30 days from the date of publication of the notice in the newspaper, and after consulting any authority, department or ministry, as he may, in his discretion, decide, determine whether the license should or should not be granted.

2 Privileges and Exemptions

According to Section 25 (2), (Ref. Section 8 under Companies Act 2013) 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(Ref. Section 8 under Companies Act 2013) (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. (Ref. Section 8 under Companies Act 2013) companies are exempted from these two provisions that apply to other types of companies.
Further, in January 2000, the RBI issued a notification that Sections 45 IA and IC19 of the RBI Act will not apply to companies registered under Section 25 of the Companies Act 1956 (Ref. Section 8 under Companies Act 2013). This exemption effectively means that Section 25 companies(Ref. Section 8 under Companies Act 2013) 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

3 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(Ref. Section 8 under Companies Act 2013) under this provision are allowed to become corporate agents of one life and/or one nonlife insurance company. They need to follow all the other relevant regulations related to IRDA.

4.4. 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 localized presence, a higher level of customer orientation than banks and lower documentation requirements albeit at higher interest rates for borrowers.

1 Definition

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:

1. Lending;
2. Receiving of deposits (as the principal business);
3. Acquisition of shares, stocks or other securities;
4. Hire-purchase or leasing;
5. Insurance;
6. Chit funds; and
7. Lotteries

2 Pre-requisites for carrying on the business of an NBFC

Capital requirement – Entry Point Norms

iii. Existing NBFCs

- All registered NBFCs intending to convert to NBFC-MFI must seek registration with immediate effect and in any case not later than October 31, 2012, subject to the condition that they shall maintain Net Owned Funds (NOF) at Rs.3 crore by March 31, 2013 and at Rs.5 crore by March 31, 2014, failing which they must ensure that lending to the Microfinance sector i.e. individuals, SHGs or JLGs which qualify for loans from MFIs, will be restricted to 10 per cent of the total assets.
- In order to provide encouragement to NBFCs operating in North Eastern Region, the minimum NOF is to be maintained at Rs.1 crore by March 31, 2012 and at Rs.2 crore by March 31, 2014.

iv. New Companies

All new companies desiring NBFC-MFI registration will need a minimum NOF of Rs.5 crore except those in the North Eastern Region of the country which will require NOF of Rs.2 crore till further notice, as hitherto and would comply,from the beginning, with all other crite

ria laid out in the following paragraphs

iii Qualifying Assets

i. NBFC-MFIs are required to maintain not less than 85 per cent of their net assets as Qualifying Assets. In view of the problems being faced by NBFCs in complying with this criteria on account of their existing portfolio, it has been decided that only the assets originated on or after January 1, 2012 will have to comply with the Qualifying Assets criteria. As a special dispensation, the existing assets as on January 1, 2012 will be reckoned towards meeting both the Qualifying Assets criteria as well as the Total Net Assets criteria. These assets will be allowed to run off on maturity and cannot be renewed.

ii. NBFC-MFIs were also required to ensure that the aggregate amount of loans given for income generation is not less than 75 per cent of the total loans extended. On reconsideration, as the target clientele is predominantly at the subsistence level and basic human requirements stand to gain priority over income generation activities, it has been decided that income generation activities should constitute at least 70 per cent of the total loans of the MFI so that the remaining 30 per cent can be for other purposes such as housing repairs, education, medical and other emergencies.

iv. Multiple Lending and Indebtedness

It is clarified that a borrower can be the member of only one SHG or one JLG or borrow as an individual. He can thus borrow from NBFC-MFIs as a member of a SHG or a member of a JLG or borrow in his individual capacity. However, a SHG or JLG or individual cannot borrow from more than 2 MFIs. Lending NBFC-MFIs will have to ensure that the above conditions are strictly complied with.

v. Ensuring Compliance with Conditionalities

Lending MFIs will have to ensure compliance with, among others, conditionalities relating to annual household income levels (Rs. 60,000/- for rural and Rs. 1,20,000/- for urban and semi urban households), total indebtedness (not to exceed Rs. 50,000/-), membership of SHG/JLG, borrowing sources (as stipulated in para 4 above) as well as percentage of qualifying assets and percentage of income generating asset (as stipulated in para 3 above.)

Membership of Credit Information Companies will facilitate ensuring compliance with many of these conditionalities. Accordingly it is reiterated that every NBFC-MFI has to be a member of at least one Credit Information Company (CIC) established under the CIC Regulation Act 2005, provide timely and accurate data to the CICs and use the data available with themto ensure compliance with the conditions regarding membership of SHG/ JLG, level of indebtedness and sources of borrowing. While the quality and coverage of data with CICs will take some time to become robust, the NBFC-MFIs may rely on self certification from the borrowers and their own local enquiries on these aspects as well as the annual household income.

vi. Pricing of Credit

As per the Malegam Committee recommendations, the interest rate cap on loans given by MFIs has been fixed at 26 per cent, under guidelines issued on December 2, 2011. However, since borrowing costs are dynamic and may exceed the costs envisaged when the Committee recommendations were made, it may be difficult for MFIs which are borrowing at rates higher than envisaged at that time to operate along viable lines, if interest rate is capped at 26 per cent. Therefore, to allow for operational flexibility, NBFC-MFIs will ensure that the average interest rate on loans during a financial year does not exceed the average borrowing cost during that financial year plus the margin, within the prescribed cap. Moreover, while the rate of interest on individual loans may exceed 26%,the maximum variance permitted for individual loans between the minimum and maximum interest rate cannot exceed 4 per cent. The average interest paid on borrowings and charged by the MFI are to be calculated on average monthly balances of outstanding borrowings and loan portfolio respectively. It has also been decided that the cap on margins as defined by Malegam Committee may not exceed 10 per cent for large MFIs (loans portfolios exceeding Rs.100 crore) and 12 per cent for the others. This measure will ensure that in a low cost environment, the ultimate borrower will benefit, while in a rising interest rate environment the lending NBFC-MFIs will have sufficient leeway to operate on viable lines. The figures may be certified annually by Statutory Auditors and also disclosed in the Balance Sheet.

vii. Capital Adequacy, Asset Classification and Provisioning Norms

In view of the problems being faced by MFIs in Andhra Pradesh many of them have had to provide sizeable amounts towards the non-performing assets in the state. To reflect the true and fair picture of the financials of the NBFC-MFI in the Balance Sheet, the provisioning made towards the AP portfolio should be as per the current provisioning norms. However, for the calculation of CRAR, the provisioning made towards AP portfolio shall be notionally reckoned as part of NOF and there shall be progressive reduction in such recognition of the provisions for AP portfolio equally over a period of 5 years.

viii. Geographical Diversification

NBFC-MFIs may approach their Boards for fixing internal exposure limits to avoid any undesirable concentration in specific geographical locations.

ix. Customer Protection Initiatives

All elements of the Fair Practices Code issued by the Bank vide DNBS.PD.CC.No.286/03.10.042/2012-13 dated July 2, 2012 will need to be adhered to by the MFIs. NBFC-MFIs must also ensure that greater resources are devoted to professional inputs in the formation of SHG/ JLG and appropriate training and skill development activities for capacity building and empowerment after formation of the groups.

x. Formation of SRO

The Malegam Committee has recommended greater responsibility to be placed on industry associations for monitoring of regulatory compliance. All NBFC-MFIs will have to become member of at least one Self-Regulatory Organization (SRO) which is recognized by the Reserve Bank and will also have to comply with the Code of Conduct prescribed by the SRO. Guidelines on the SRO structure will follow shortly.

xi. Monitoring of Compliance

The responsibility for compliance to all regulations prescribed for MFIs lies primarily with the NBFC-MFIs themselves. The industry associations/SROs will also play a key role in ensuring compliance with the regulatory framework. In addition, banks lending to NBFC-MFIs will also ensure that systems practices and lending policies in NBFC-MFIs are aligned to the regulatory framework.

xii. Application for Registration as NBFC-MFIs

All existing NBFCs intending to be registered as NBFC-MFIs must seek registration with immediate effect as stipulated in para 2(i)(a) to the Regional Office in the jurisdiction of which their registered office is located along with the original Certificate of Registration (CoR) issued by the Bank for change in their classification as NBFC-MFIs. The change in classification would be incorporated in the CoR as NBFC-MFI.

4.5 NIDHI COMPANIES (Ref. Section 406 under Companies Act, 2013)

Section 620 (Ref. Section 406 under Companies Act 2013) of the Companies Act allows for the formation of a special type of company called 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

1 ACCEPTANCE OF DEPOSIT

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.

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 inany 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.

2 Audit

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.

CHAPTER 5: PRODUCTS OF MICROFINANCE

5.1 OBJECTIVE

- To ameliorate the socio-economic conditions of the weaker sections of the society by providing timely and adequate access to credit

- To function as a pioneering, development oriented, community based institution in financial intermediation for rural and urban poor
- To establish long term linkages with poor families and their informal community based organizations by extending financial and non financial services
- To enhance income levels of rural poor by promoting micro enterprises in farm and non-farm sectors
- To promote home ownership, housing upgradation and community infrastructure among weaker sections and lower income groups of the society
- To design financial instruments that meet the savings, credit and insurance needs of the target group
- To develop linkages with formal sector financial institutions and international funding agencies
- To sustain as a credible role model for upcoming Micro Finance Institutions (MFIs)

Microfinance institutions have largely limited their product and service offering even within the confines of financial inclusion. The limited product innovation understandable given the sector's primary focus has been on refining its business model and gaining scale to become financially sustainable. Despite following a single-product model, the sector has experienced remarkable growth. This growth can only be expected to continue as product innovation and diversified service offerings attract and retain greater number of customers with a variety of needs

5.2 Microsavings

Accumulated savings can buffer expected or unexpected spikes in household expenses due to childbirth, school fees, home repairs, life-cycle celebrations, or widowhood (by death, divorce, or abandonment). Savings may also cushion familial risks due to illness, theft, or job loss or structural risks due to war, floods, or fire. Finally, savings allow people to take advantage of unexpected investment opportunities.

Sr.NO	Type of Loan Products Offered	Purpose
1	Micro-enterprise /small business loan	Working capital/business start-up
2	Agricultural Loan	Crop/Farm-related
3	Livestock Loan	Dairy/Poultry

4	General	Consumption
5	Education Loan	Academic/vocational
6	Housing Loan	Home improvement/new home

5.3 INSURANCE

While credit can serve to enhance a household's income, insurance can serve to cushion the negative economic impact in the event of an emergency. Without insurance, a single incident can often impoverish a household, even with access to micro-credit, especially if the emergency affects the main earning members. A number of MFIs already offer micro insurance products to their clients. The most basic products insure against health and accidental death. The rationale behind packaging the loan and insurance together is that often clients do not understand the importance or benefit of insurance until they face an emergency. From a commercial viewpoint, the MFI is in effect insuring its loan against a crisis in the client's household, since insurance hedges against total financial collapse and thus ensures repayment of the loan, albeit in a delayed fashion

Microinsurance

India has many informal insurance schemes. These schemes are often small, run by cooperatives, churches and non-governmental organizations (NGOs), which pool their members' contributions to create an insurance fund for a specific purpose, for example to cover funeral costs. In some countries, there is specific legislation to regulate these schemes, however in India, no such law exists; any organization conducting insurance has to comply with the stipulations of, among other regulations, the 1938 Indian Insurance Act as amended. In the community-based model, a group of people get together and essentially develop their own insurance scheme in which they pool their own funds and develop their own rules. In the in-house or full-service model, an MFI or NGO runs its own insurance scheme for its clients and any profit or loss is absorbed by the MFI. The passage of the Rural Social Sectors' Obligations changed the Indian Microinsurance landscape dramatically. This requirement has motivated insurers to seek partnerships with MFIs and NGOs to act as agents, selling and servicing the insurers' policies. This model of collaboration, the partner-agent model, has become the dominate approach to microinsurance in India and has encouraged many MFIs to switch from a full-service to a partner-agent approach.

5.4 REMITTANCE

Domestic labor migration has a long history in India and is on the rise given disparities in growth across states – migrants need a fast, low-cost, convenient, safe and widely accessible money transfer service. In India, remittance services safe and widely accessible money transfer service. In India, remittance services can be enabled by the provision of savings and thus need to be provided in tie-ups with banks and post offices. In some cases, MFIs provide remittance service by establishing their presence in a migrant destination to channel remittances back to the community in the migrants' area of origin or by establishing a tie-up with another MFI, bank or money transfer company in the area of origin. Going forward, the role of technology will become more important in facilitating the development of alternative channels and payment mechanisms.

5.5 NON-FINANCIAL PRODUCTS

Within product offerings, MFIs are considering expanding their activities beyond the realm of financial services since this can provide synergies linked to future expansion. Microfinance clients have myriads of unmet needs such as healthcare and education as well as livelihood requirements which can enhance their income, employment potential or quality of life. Given MFIs' existing relationships with this population segment, they would be an ideal channel to provide these services. While MFIs may not want to delve into product lines that are fundamentally different from their core business, they could easily act as conduits to allow other agents to deliver these services to their customers. The microfinance industry as a whole is now experimenting with a wide variety of potential models that could be used to deliver non-financial services, In addition to livelihood services, several MFI are examining the feasibility of providing critical basic services to deliver low cost healthcare, education and vocational training. In addition to being important avenues for productive utilization of credit by MFI clients, these types of services have a strong potential In addition to being important avenues for productive utilization of credit by MFI clients, these types of services have a strong potential. several MFIs are examining the feasibility of providing critical basic services to deliver low cost healthcare, education and vocational training. Since MFIs' asset growth rates may be more moderate over the medium term, they will need to make strategic choices based on their capabilities and the competitive environment

5.6 INVESTMENTS CRITERION

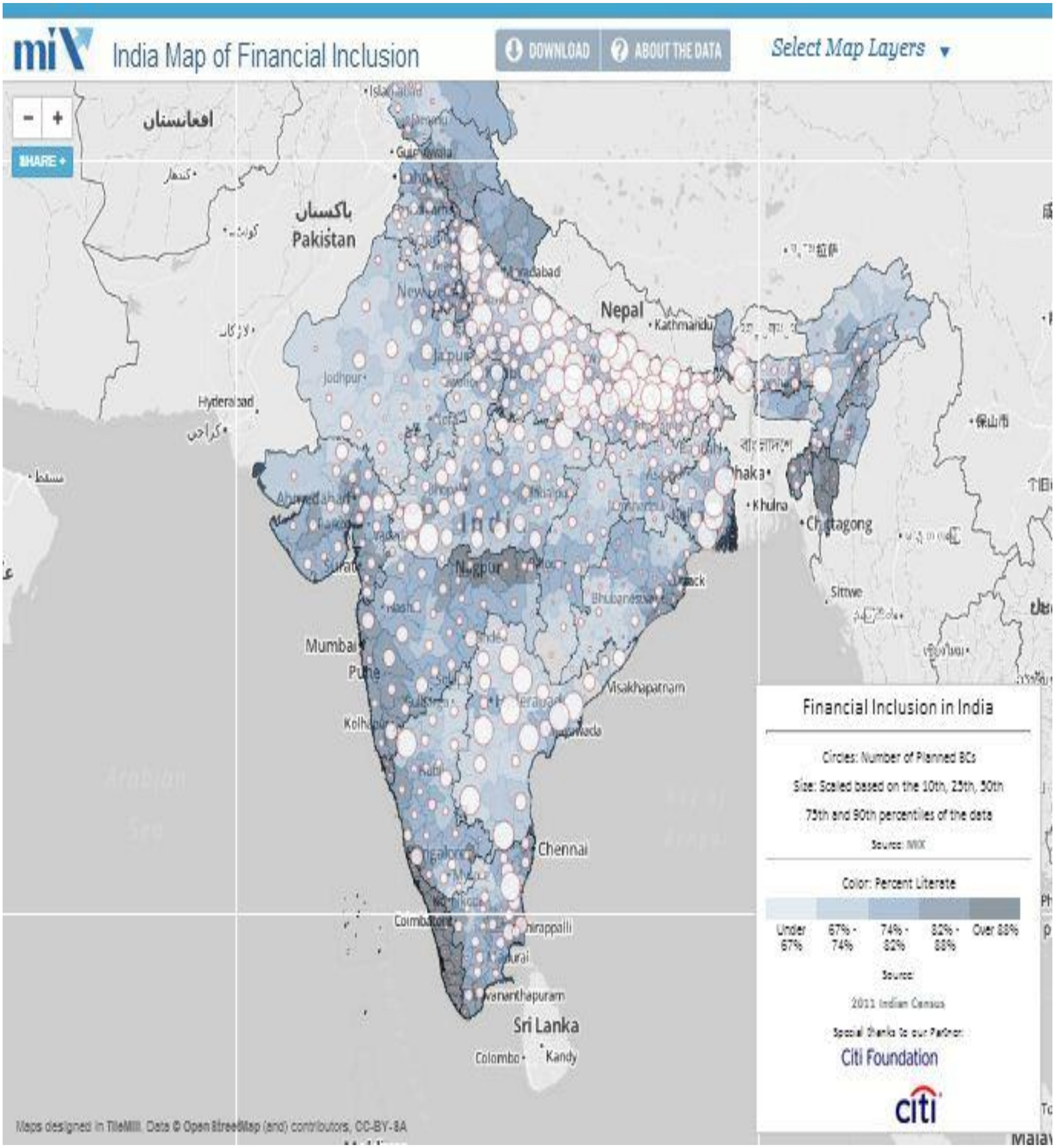
Today, microfinance is gaining prominence as a viable asset class globally, particularly in India. MFIs in India have continued to attract large amounts of capital despite the global economic recession. Currently, it is reported that over 100 microfinance investment vehicles ("MIVs") exist globally, and India is a focus for many of them due to its large market size, growth capacity, profitable business models and potential development impact. Moreover, mainstream investors are beginning to participate in this sector, picking up larger stakes than the social investors that have been dominant so far. The entrance of mainstream investors is indicative of an industry that is maturing, but is still expected to grow at a high rate. Valuations in the microfinance sector reflect this expectation and surpass that of traditional institutions in the financial services space. Moreover, Indian MFIs trade at significant premia to MFIs in other parts of the world. the microfinance industry is reaching maturity, the large amounts of untapped geographical territory and client base combined with the MFIs' wide network create potential for enormous sustainable growth in the future. the microfinance industry is reaching maturity, the large amounts of untapped geographical territory and client base combined with the MFIs' wide network create potential for enormous sustainable growth in the future.

5.7 JOINT LIABILITY GROUP PRODUCT

The joint liability scheme is one of the alternatives found which could be implemented and has generated mixed results in the terms of success. That is, it has been successful in few locations and has been failure at few locations. Hence this has raised interest in the various researchers to explore and study the factors responsible for both the success and failure of the joint liability schemes around the world. This paper is an attempt to understand the concepts involved in the joint liability scheme and identify the factors which directly or indirectly impact the performance on the repayments. At the same time also find the factors which differentiate the joint liability property from the individual liability.

The joint liability has been successful implemented in the Bangladesh for decades. The target clients had possessed no physical assets in order to provide as collateral for loans to lenders. This has made microfinance institutes to undertake the social cohesion as the collateral for the loans provided. Hence the client's need to form the groups in order to apply for the loans from the lenders where every member would be eligible to undertake a loan Here in the group credit it is the joint liability which is undertaken as the collateral for the loan provision where as in the developed society, an individual would be able to access the higher loan amounts only in individual liability scheme. As the group credit would not be able to meet the requirements like progressive increment in the loan amounts etc The community development activities have looked in to the possibility of the provision of loans to the lower part of the society in a group or joint liability schemes. This scheme involved in the provision of the loans to the individual on the basis of the surety from the other group members as the collateral. Many of the NGOs and the government organizations in the developing nations have heavily depended on the joint liability to serve the lower part of the society. Hermes & Lensink (2007) paper describes the basic model used which was to provide the loans to the group of people either at once to all the group's members or in parts. However the critical criteria general laid were to non provision of further loans to all the members of the group in case of default by one or more members of the group, Availability of the local information in the joint liability provides the advantage of lower costs incurred in the monitoring by the lending organization

CHAPTER 6: FINANCE INCLUSION AND RBI MANDATE



India Map of Financial Inclusion
DOWNLOAD
ABOUT THE DATA
Select Map Layers
SHARE +
Pakistan
Nepal
Kathmandu
Jodhpur
Hyderabad
Khulna
Chittagong
Sittwe
Mumbai
Visakhapatnam
Chennai
Sri Lanka
Colombo
Kandy
Financial Inclusion in India
Circles: Number of Planned BCs
Size: Scaled based on the 10th, 25th, 50th
75th and 90th percentiles of the data
Source: MIX
Color: Percent Literate
Under 67%
67% - 74%
74% - 82%
82% - 88%
Over 88%
Source:
2011 Indian Census
Special thanks to our Partner:
Citi Foundation
citi
Maps designed in TileMill. Data © OpenStreetMap (and) contributors, CC-BY-SA

The Reserve Bank of India (RBI) set up the Khan Commission in 2004 to look into financial inclusion and the recommendations of the commission were incorporated into the mid-term review of the policy (2005–06). RBI urged that the banks to make available a basic "no-frills" banking account to facilitate greater financial inclusion.

In India, Mangalam became the first village where all households had access to banking facilities.

In January 2006, the RBI permitted commercial banks to make use of non-governmental organizations (NGOs/SHGs), micro-finance institutions, and other civil society organizations as intermediaries for providing financial and banking services to the unbanked population. These intermediaries could be used as business facilitators or business correspondents by commercial banks.

RBI has initiated several measures to achieve greater financial inclusion like facilitating no-frills accounts and GCCs for small deposits and credit. Some of these steps are:

Opening of no-frills accounts: A typical no-frills account is an account having basic banking facilities with nil or very low minimum balance as well as charges that make such accounts accessible to vast sections of the population.

Relaxation on know-your-customer (KYC) norms: KYC requirements for opening bank accounts were relaxed for small accounts in August 2005. The procedures were simplified by stipulating that introduction by an account holder who has been subjected to the full KYC drill would suffice for opening such accounts. The banks were also permitted to take any evidence as to the identity and address of the customer to their satisfaction. It has now been further relaxed to include the letters issued by the Unique Identification Authority of India containing details of name, address and Aadhaar number.

Engaging business correspondents (BCs): RBI has now permitted banks to use the business facilitators (BFs) and BCs as intermediaries for providing financial and banking.

The BC model allows banks to provide doorstep delivery of services. This includes cash in-cash out transactions. This takes care of the last-mile reach of the banks.

Use of technology: Recognizing that technology has the potential to address the issues of outreach and credit delivery in rural and remote areas in a viable manner, banks have been advised to make effective use of information and communications technology (ICT) to provide doorstep banking services through the BC model where the accounts can be operated by even illiterate customers by using biometrics, thus ensuring the security of transactions and enhancing confidence in the banking system.

Simplified branch authorization: To address the issue of uneven spread of bank branches, in December 2009, domestic scheduled commercial banks were permitted to freely open branches in tier III to tier VI centres with a population of less than 50,000 under general permission, subject to reporting. In the north-eastern states and Sikkim, domestic scheduled commercial banks can now open branches in rural, semi-urban and urban centres without the need to take permission from RBI in each case, subject to reporting.

Opening of branches in unbanked rural centres: To further step up the opening of branches in rural areas so as to improve banking penetration and financial inclusion rapidly, the need for the opening of more bricks and mortar branches, besides the use of BCs, was felt. Accordingly, banks have been mandated in the April monetary policy statement to allocate at least 25% of the total number of branches to be opened during a year to unbanked rural centres.

The commercial banks in different regions have started a 100% financial inclusion campaign as a result of which the states or union territories like Puducherry, Himachal Pradesh and Kerala announced 100% financial inclusion in all their districts.

RBI's vision for 2020 is to have nearly 600 million new customers' accounts and service them through a variety of channels by leveraging on Information Technology. The major challenges in making this a reality would be illiteracy, low income savings and lack of bank branches in rural areas.

MFI PENETRATION AND SPREAD OF BANKING SERVICES IN INDIA

India has a strong network of public sector banks but availability of banking services in different parts of the country is non-uniform. In places where there is inadequate availability of banking services, the supply side barriers to financial inclusion are particularly high, making availability of MFI services particularly useful. Even though banks often themselves do not provide service tailor made for low income groups, they often partner with Non Government organization (NGOs) through the self help group bank linkage program promoted by the National Bank for Agriculture and Rural Development (NABARD). Hence low income groups in areas with bank branches are often able to access financial services through this route. In this section, we seek to assess if MFIs fill in spatial gaps in banking services by showing high levels of penetration in areas neglected by the banking sector. While financial inclusion is an objective in many developed and developing countries, the most cost effective means for financial inclusion needs to be evolved depending on the culture as well as the institutional and legal infrastructure in the country. For instance, matched savings programs have been tried in Australia and USA. However such programs require high budgetary resources and may not be a feasible option in the case of many low income countries. MFIs represent a good vehicle for promotion of financial inclusion in developing countries such as India. It microfinance penetration in the country was non-uniform, with state specific contextual factors playing a major role in driving microfinance growth. A comparison of the spread of microfinance services with that of banking services, found four distinct regional categories. While the Southern and Western regions were characterized by widespread availability of both kinds of services, the Central region had low availability of both kinds of services. The Eastern and North Eastern regions showed high availability of microfinance but not banking services, while the Northern region showed high availability of banking but not microfinance services. This suggests the need to develop the microfinance sector in inadequately served regions. Targeted incentive packages at the national level to encourage the spread of microfinance to these areas could be useful. The interviews with field workers suggests that there are individuals who want to access microfinance, but are not able to do so due to various reasons. These include requirements such as attendance at weekly group meetings, documentation such as address proof, and a lack of a market-oriented economic activity. The findings also indicate that microfinance does not imply ongoing access to financial services, as it is found in a number of cases that access is temporary as members drop-out. There is a need for greater portability of microfinance accounts, in order to address drop-outs due to migration and marriage. Such portability could also reduce overall resource costs of providing microfinance services.

MFIs do break down many barriers to financial inclusion, there are limitations in that MFI penetration in the country is skewed and excludes some areas neglected by the banking sector, suggesting a need for policy incentives

CHAPTER 7: <u>FINANCIAL REPORTING OF MICROFINANCE</u>

7.1 TYPES OF SOURCES

There are mainly two sources for meeting the funding requirements of the MFI's.

A) External sources like promoters contribution, equity capital including investment by private equity fund agencies/ venture capitalists etc. The MFI's get funds through External commercial debts, grants from various national and international organizations, corporate donors, High Networth Individual (HNI) donors, promotional funds from SIDBI and NABARD etc.

B) Internal Sources like income from operations and investment income etc. Ultimately the efficiency of an MFI is decided on the basis of its operational efficiency and its ability to generate sufficient income on a self sustainable basis. In the case of some MFI's income may flow through fee collected from training etc.

7.2 ACCOUNTING PRACTICES FOLLOWED

There are different organizational structures adopted by the MFI's. The laws and legal formalities applicable to such different organisations differ. Some trusts registered under the Indian trust act and others prepare and present the accounts according to their whims and fancies since such laws do not contain provisions relating to accounts.

7.3 FINANCIAL REPORTING

There exist various interest groups who require different kinds of information from the accounts of the organization. For eg the Income Tax Department may be most interested in the calculation of net profit and the classification of expenditure as revenue or capital, since only revenue expenditure are allowed as deduction. They are also interested in the information relating to donations and whether it is corpus donation or not since corpus donations do not form part of income taxable. Likewise donors may be interested in the figures relating to utilization of their donation and how effectively it was spent. Bankers and other debt providers may be interested in the information relating to interest coverage vis-a -vis the net profit and the efficiency of repayment etc. Thus the financial accounts preparation and reporting has to be fine tuned in such a way as to satisfy to the maximum extent possible the requirements of the users of the financial reports.

7.4 USERS OF FINANCIAL REPORTS

The following are the persons who are interested in the financial reporting of Microfinancial Institutions.

1. The donors
2. Grantors
3. Creditors
4. Owners
5. Employees
6. Directors and Trustees
7. Beneficiaries
8. Financial Analysts
9. Government
10. Economists
11. Sociologists
12. Financial press
13. General public
14. Government agencies etc

7.5 METHODS OF ACCOUNTING

They are two methods of Accounting, Cash system of accounting and Accrual system of accounting. A hybrid of the above two systems are also followed. In the case of cash system of accounting transactions are recorded when the relative cash receipts are actually received or when the expenses are actually paid out. Accrual system of accounting on the other hand would record transactions as when the right to receive the revenue arises or the liability to pay the expenditure is incurred. It is pertinent to note that under the Companies Act 1956 vide Section 209(3)(b) it is mandatory to follow the accrual system of accounting. It is to be noted that Section 145 of the Income Tax Act allows a person to follow either of the two methods. But accrual basis of accounting would be preferable since the same is more scientific and conceptually superior to cash system. Thus the MFI's are free to choose the method as may be found suitable to them except in the case of MFI's which are companies where it is compulsory to follow accrual system.

7.6 APPLICABILITY OF ACOUNTING STANDARDS

Accounting standards are designed to apply to the general purpose financial statements and other financial reporting which are subject to the attest function of the members of the Institute of Chartered Accountants of India (ICAI). The ICAI is of the opinion that micro finance activities are of a commercial nature even though the objectives may be charitable or non- profit. Thus the various accounting standards issued by the ICAI are applicable to such MFI's and the same would help maintaining the uniformity in the presentation of accounts. Even where the same is not applicable still it is recommended that the standards may be followed. As such Accounting Standards (AS) 1 to AS 7 and AS 9 to AS 29 shall be applicable to MFI's.

7.7 PROFIT AND LOSS ACCOUNT (INCOME AND EXPENDITURE ACCOUNT) FORMAT

The Income of MFI's can be broadly classified into two groups as stated below.

A) Income from Financial Services and
B) Other Income.

A) Income from Financial Services would include interest on loan, fees and service charges like training fee, loan processing fee, application fee etc, insurance commission and technical and consultancy fees.
B) Other Income would include grants received from various government and private institutions, interest on investments and miscellaneous income.

7.8 FORMAT OF BALANCE SHEET

The Balance sheet of an MFI may be drawn up in the manner described below.

A) Sources of Funds

Divided into broad 3 categories as
1. Shareholders funds
2. Loan Funds
3. Deferred Tax liability.

Shareholders funds may be further divided into share capital or general capital fund and Reserves and surplus. Loan Funds may be classified as secured and unsecured. Those liabilities which fall due with in a short period say one year may be shown as current liabilities.

B) Application of Funds

Divided into categories viz Fixed assets, Loans and Advances, Investments, Current assets net of Current liabilities and Miscellaneous items including Deferred Tax Assets.

CHAPTER 8: TAXATION OF MICROFINANCE

8.1 SOCIETIES AND TRUSTS

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 organizations. 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 Section13/3, subject to certain exceptions.

8.2 NBFCs AND OTHER LOCAL BANKS

NBFCs 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.

8.3 CO-OPERATIVE SOCIETIES INCLUDING MULTI STATE CO-OPERATIVE SOCIETIES

Co-operative Societies, including Multi State Co-operative Societies (MACS) are subject to taxation on their surpluses as per the regulation.

8.4 CO-OPERATIVE BANKS

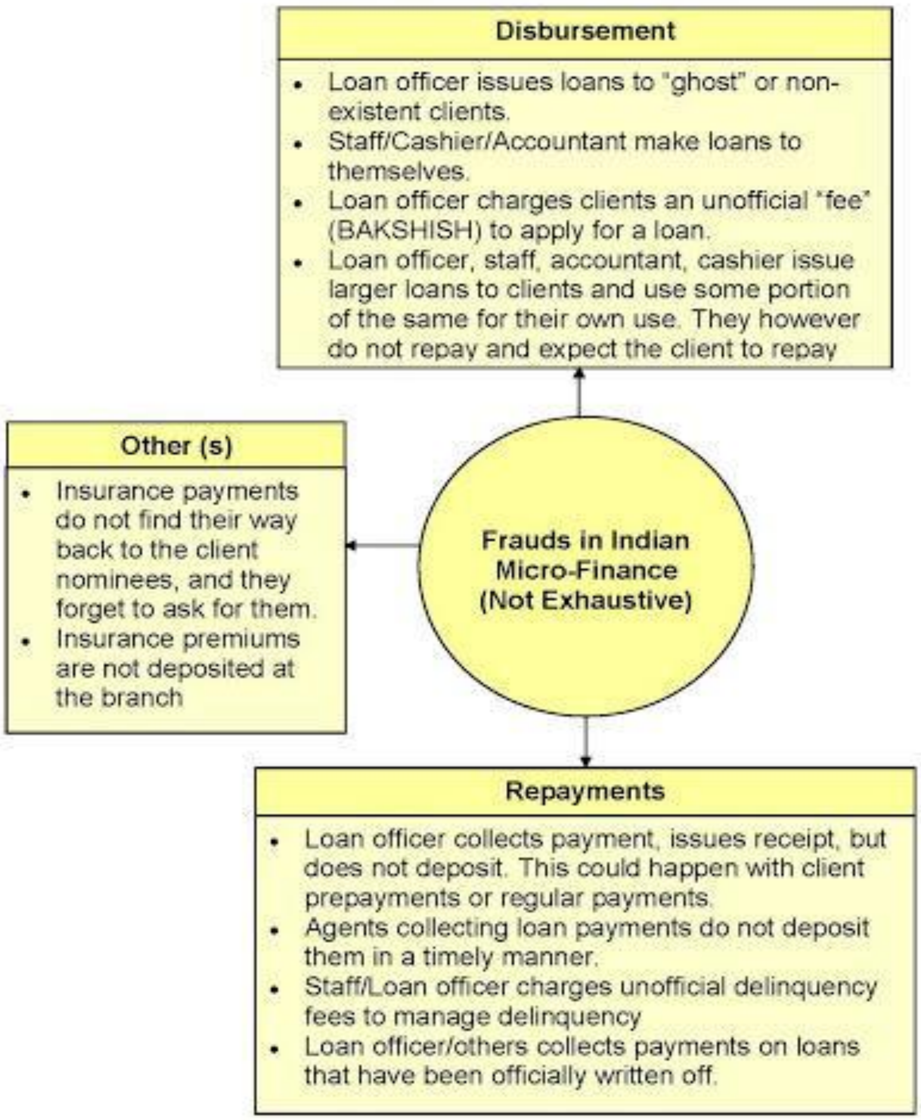
Co-operative Banks have to pay Income Tax as per the provisions of the Income Tax Act 1961. Their income is subject to taxation and any surplus over the expenses , before the payment of dividend and provision to reserves is taxed as per the provisions laid down in the Income Tax Act.

8.5 SECTION 25 COMPANIES (Ref. Section 8 under Companies Act 2013)

Being an entity engaged in non-profit activities and not sharing its surplus amongst shareholders, section 25 companies (Ref. Section 8 under Companies Act 2013)are exempt from paying tax under Section 12(1) of the Income Tax Act 1961.For the microfinance Institutions falling in the non-for-profit category(i.e. Societies, Trusts and section 25 companies(Ref. Section 8 under Companies Act 2013)) section 115 BBC of the Income Tax Act 1961 relating to anonymous donation also applicable among other provisions of the Act, According to the Act," Anonymous Donation" means any voluntary contribution referred to in sub-clause (iia) of clause(24) of the section 2, where a person receiving such contribution does not maintain a record of the identity indicating the name and address of the person making such contribution and such other particulars as may be prescribed. The anonymous donation received by any enterprise for charitable purpose other than religious cause shall be included in the total income of the enterprise and taxed at the rate of 30 percent.

CHAPTER 9: FRAUDS IN MICROFINANCE INSTITUTIONS

9.1 WAYS OF UNDERTAKING FRAUDS



9.2 EXAMPLES OF FRAUD

1. Fieldworkers who were collecting repayment from clients, for long withheld the fact that several clients had been making prepayments as well – i.e., higher than

required repayments. What happened was that suddenly, the institution discovered significant amounts paid by clients had not been remitted by fieldworkers and there was a huge loss to the MFI. Clients refused to pay up the already paid amounts and while some fieldworkers absconded, others simply said they could not pay back to the institution as they did not have the money. A variant of this observed at another institution is that fieldworkers were often found to classify regular client payments as delinquent and not turn in some or all of the client money. In both cases, apart from loss of money, institutions concerned also suffered loss of reputation, especially with clients and investors.

2. Some institutions lend with a norm of a client bringing a fraction of the loan as their margin money/security deposit. In one such institution, field workers utilized this option to their advantage. For example, if clients were required to bring in 10% of the loan amount, and say, brought in Rs.500 for a loan of Rs.5000, there are instances where fieldworkers have added another Rs.500/- to make the margin money or security deposit as Rs.1000/- and enhanced the loan amount to Rs.10,000 and soon. When the loan reaches the client, Rs.5000/- is kept by the client and the balance of Rs.5000/- is taken away by the fieldworkers and utilized for other purposes including lending in the local market at high/usurious rates of interest. Repayment problems have compounded when fieldworkers have left the organization - clients have refused to pay back half of the 'loan' that they never received in the first place. This is a classic case of institutional failure of non-repayment induced by an external factor and the concerned institutions have incurred significant losses.

3. An NGO was linking groups to commercial banks. Suddenly, it was found that the Fieldworkers were taking back a significant proportion of the loan [almost 30%] and the groups had kept quiet for some time – by which time a significant amount of money had been collected. However, in field visits by bankers, this came to light and some fieldworkers/NGO were made to return some money but losses were incurred as groups refused to repay. The confidence of the bankers was so dented that even after several years, they do not lend significantly in that area. Apart from loss of money, there was also loss of reputation.

4. Group leaders collected upfront commissions on loans given by NGO-MFI to the groups. Between 20-55% of loan amounts were said to be taken by them. At time of repayment, some of the members defaulted stating that they did not receive the full loan amount in the first place. Here, there are two kinds of institutional failures: 1) failure of differential access; and 2) failure of non-repayment.

5. In another case, in several groups, a small proportion of loans disbursed were actually utilized by members while the remaining was utilized by field officers of a government sponsored program who were later found guilty of lending the same at usurious rates to the local public. This case attracted significant media attention as well.

6. A financial intermediary lost a large amount of cash kept at the branch due to theft. Neither was the branch insured nor was there adequate safety in terms of a safe/strong room, guards and other required controls including segregation of duties. Another institution lost a large sum of money in transit when cash was transported from head quarters to branches and vice versa."

9.3 COMMON CONDITIONS MAKING MICRO FINANCE INSTITUTIONS ATTRACTIVE TOWARDS FRAUDS:-

- They are experiencing very rapid growth
- Their MIS and accounting systems are weak
- Their systems are constantly undergoing change
- Their internal control systems are inadequate and constantly being stressed and sheared
- Their employee turnover is high
- Their loan officers handle excessive and increasing amounts of cash
- Their policies and systems are not followed because of their decentralised model and internal audits are either weak or are almost non-existent.
- Their governance is weak and non-transparent, with significant related party transactions.

9.4 SUMMARY OF REASON FOR FRAUDS

1. Lack of adequate management oversight and accountability, and failure to develop a strong control culture within the institution. Without exception, cases of loss reflect management inattention to, and laxity in, the control culture of the institution, insufficient guidance and oversight by boards of directors and senior management, and a lack of clear management accountability through the assignment of roles and responsibilities. These cases also reflect a lack of appropriate incentives for management to carry out strong line supervision and maintain a high level of control consciousness across the organization.

2. Inadequate recognition and assessment of the risk of certain activities, whether on- or off-balance sheet. Many organizations that have suffered losses neglected to recognize and assess the risks of new products and activities, or update their risk assessments when significant changes occurred in the environment or business conditions including growth. Many recent cases highlight the fact that control systems that function well for traditional or simple products are unable to handle more sophisticated or complex products, especially in burgeoning growth.

3. The absence or failure of key control structures and activities, such as segregation of duties, approvals, verifications, reconciliations, and reviews of operating performance. Lack of segregation of duties in particular has played a major role in the losses that have occurred.

4. Inadequate communication of information between levels of management within the institution, especially in the upward communication of problems. To be effective, policies and procedures need to be effectively communicated to all personnel involved in an activity. Some losses occurred because relevant personnel were not aware of or did not understand the policies. In several instances, information about inappropriate activities that should have been reported upward through organizational levels was not communicated to the board of directors or senior management until the problems became severe. In other instances, information in management reports was not complete or accurate, creating a falsely favorable impression of a business (portfolio) situation.

5. Inadequate or ineffective audit programs and monitoring activities. In many cases, internal audits were not sufficiently rigorous to identify and report the control weaknesses. In other cases, even though auditors reported problems, no mechanism was in place to ensure that management corrected the deficiencies.

CHAPTER 10 : CODE OF CONDUCT FOR MICROFINANCE INSTITUTIONS

All Microfinance Institutions are required to follow all regulatory norms as well as consumer protection practices (specifically, RBI's Guidelines on Fair Practices issued for NBFCs) laid down by the government and the regulators in both letter and spirit. The Code of Conduct lays down additional requirements to enhance and improve sector practices. The code of conduct is to be followed by all MFIs regardless of their form.

10.1 APPLICATION OF THE CODE:

This Code applies to the following activities undertaken by Microfinance Institutions:

1. Providing credit services to clients, individually or in groups.
2. Recovery of credit provided to clients.
3. Collection of thrift from clients, where ever applicable.
4. Providing insurance and pension services, remittance services, or any other related
5. products and services.
6. Formation of any type of community collectives including self-help groups, joint liability groups and their federations.
7. Business development services including marketing of products or services made or extended by the eligible clients or for any other purpose for the welfare and benefit of clients.

1. INTEGRITY AND ETHNICITY

MFIs must design appropriate policies and operating guidelines to treat clients and employees with dignity. MFIs must incorporate transparent and professional governance system to ensure that staff and persons acting on their behalf are oriented and trained to pu this Code into practice. MFIs must educate clients on the Code of Conduct and its implementation

2. TRANSPARENCY

MFIs must disclose all terms and conditions to the client for all services offered. Disclosure must be made prior to disbursement in accordance with the Reserve Bank of India's (RBI) fair practices code, in any of the following ways:

a) Individual sanction letter
b) Loan card
c) Loan schedule
d) Passbook

Through Group/Centre meetings (Details can be printed on a paper and al borrowers can sign on the same as acknowledgement of their acceptance) MFIs must communicate all the terms and conditions for all products/service offered to clients in the official regional language or a language understood by them.

At the minimum, the MFI must disclose the following terms:

a) Rate of interest on a reducing balance method

b) Processing fee
c) Any other charges or fees howsoever described
d) Total charges recovered for insurance coverage and risks covered

MFIs must communicate in writing, charges levied for all financial services rendered. Fee on non-credit products/services will be collected only with prior declaration to the client.

MFIs must declare all interest and fees payable as an all-inclusive Annual Percentage Rate (APR) and equivalent monthly rate.
MFIs must follow RBI's guidelines with respect to interest charges and security deposit.

Formal records of all transactions must be maintained in accordance with all regulatory and statutory norms, and borrowers' acknowledgment/acceptance of terms/conditions must form a part of these records
.

3. CLIENT PROTECTION

a) Fair Practices

MFIs must ensure that the provision of micro finance services to eligible clients is as per RBI guidelines

MFIs must obtain copies of relevant documents from clients, as per standard KYC norms. Additional documents sought must be reasonable and necessary for completing the transaction
.
Products should not be bundled. The only exceptions to bundling may be made with respect to credit life, life insurance & live-stock insurance products, which are typically offered bundled with loans. The terms of insurance should be transparently conveyed to the client and must comply with RBI & Insurance Regulatory and Development Authority (IRDA) norms. Consent of the client must be taken in all cases
.

b) Avoiding Over-indebtedness

MFIs must conduct proper due diligence as per their internal credit policy to assess the need and repayment capacity of client before making a loan and must only make loans commensurate with the client's ability to repay.

If a client has loans from 2 separate lenders, then irrespective of the source of the loans, a MFI shall not be the third lender to that client.

MFIs must not, under any circumstance, breach the total debt limit for any client, as prescribed by RBI or Central/State Government(s).

c) Appropriate interaction and collection practices

MFIs must ensure that all Staff and persons acting on behalf of the MFI

a) Use courteous language, maintain decorum, and are respectful of cultural sensitivities during all interaction with clients.

b) Do not indulge in any behavior that in any manner would suggest any kind of threat or violence.

c) Do not contact clients at odd hours, as per the RBI guidelines for loan recovery agents.

d) Do not visit clients at inappropriate occasions such as bereavement, sickness, etc., to collect dues.

3. MFIs must provide a valid receipt (in whatever form decided by the MFI) for each and every payment received from the borrower.

4. MFIs must have a detailed Board approved process for dealing with clients, at each stage of default.

5. MFIs must not collect shortfalls in collections from employees and their HR policies must categorically denounce this practice. An exception can however be made in proven cases of frauds by employees.

d) Privacy of client information

MFIs must keep personal client information strictly confidential. Client information may be disclosed to a third party subject to the following conditions:

a) Client has been informed about such disclosure and permission has been obtained in writing.

b) The party in question has been authorized by the client to obtain client information from the MFI.

c) It is legally required to do so.

d) This practice is customary amongst financial institutions and available for a close group on reciprocal basis.

4. GOVERNANCE

MFIs must incorporate a formal governance system that is transparent and professional, and adopts the following best practices of corporate governance:

MFIs must observe high standards of governance by inducting persons with good and sound reputation as members of Board of Directors/Governing body.

MFIs must endeavor to induct independent persons to constitute at least 1/3rd of the Governing Board, and the Board must be actively involved in all policy formulations and other important decisions
.

MFIs must have a Board approved debt restructuring product/program for providing relief to borrowers facing repayment stress.

MFIs will appoint an audit committee of the Board with an independent director as chairperson.

MFIs must ensure transparency in the maintenance of books of accounts and reporting/ presentation and disclosure of financial statements by qualified auditor/s.

MFIs must put in best efforts to follow the Audit and Assurance Standards issued by the Institute of Chartered Accountants of India (ICAI).

MFIs must place before the Board of Directors, a compliance report indicating the extent of compliance with this Code of Conduct, specifically indicating any deviations and reasons therefore, at the end of every financial year.

5. RECRUITMENT

The code covers all MFI staff.

As a matter of free and fair recruitment practice, there will be no restriction on hiring of staff from other MFIs by legitimate means in the public domain like general recruitment advertisements in local newspapers, web advertisements, walk-in interviews, etc.

Whenever an MFI recruits from another MFI, it will be mandatory to seek a reference check from the previous employer. The reference check will be sought from current employer only after an offer is made and an offer letter is issued to the prospective employee.

MFIs should respond to the reference check request from another MFI within two weeks.

MFIs must honor a one month notice period from an outgoing employee.

No MFI shall recruit an employee of another MFI, irrespective of the grade/level of the employee, without the relieving letter from the previous MFI employer. An exception can however be made in instances where the previous employer (MFI) fails to respond to the reference check request within 30 days. All MFIs must provide such relieving letter to the outgoing employee in case he/she has given proper notice, handed over the charge and settled all the dues towards the MFI, except in proven cases of fraud or gross misconduct by the employee.

6. CLIENT EDUCATION

MFIs must have a dedicated process to raise clients' awareness of the options, choices and responsibilities vis-à-vis financial products and services available.

New clients must be informed about the organization's policies and procedures to help them understand their rights as borrowers.

MFIs must ensure regular checks on client awareness and understanding of the key terms and conditions of the products/ services offered / availed.

7. DATA SHARING

MFIs will agree to share complete client data with all RBI approved Credit Bureaus, as per the frequency of data submission prescribed by the Credit Bureaus.

8. FEEDBACK/ GRIEVANCE REDRESSAL MECHANISM

MFIs must establish dedicated feedback and grievance redressal mechanisms to correct any error and handle/receive complaints speedily and efficiently.
MFIs must inform clients about the existence and purpose of these mechanisms and how to access them.

MFIs must designate at least one grievance redressal official to handle complaints and/ or note any suggestions from the clients and make his/ her contact numbers easily accessible to clients.

Each MFI will have an appropriate mechanism for ensuring compliance with the Code of Conduct.

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Where complainants are not satisfied with the outcome of the investigation conducted by the concerned MFI into their complaint, they shall be notified of their right to refer the matter to the grievance redressal mechanism established by the Industry Associations.

10.2 INSTITUTIONAL CONDUCT GUIDELINES FOR MICROFINANCE INSTITUTIONS

Shall have an appropriate mechanism for ensuring compliance with the Code of Conduct

.

Shall have appropriate policies and operating guidelines to treat clients and employees with dignity.

Shall maintain formal records of all transactions in accordance with all regulatory and statutory norms, and borrowers' acknowledgement/acceptance of terms/conditions must form a part of these records.

Shall have detailed board approved process for dealing with clients, at each stage of default.

Shall not collect shortfalls in collections from employees except in proven cases of frauds by employees.

Shall have a Board approved debt restructuring product/program for providing relief to borrowers facing repayment stress.

Shall seek a reference check from previous employer for any new hire.

Shall provide within 2 weeks the reply to the reference check correspondence fo another MFI.

Shall honour a one month notice period from an outgoing employee.

Shall not recruit an employee of another MFI without the relieving letter from the previous MFI employer except where the previous employer (MFI) fails to respond to the reference check request within 30 days.

Shall not assign a new employee recruited from another MFI, to the same area he/she was serving at the previous employer, for a period of 1 year. This restriction applies to positions up to the Branch Manager level.

Shall have a dedicated process to raise the client's awareness of options, choices, rights and responsibilities as a borrower and shall conduct regular checks on client awareness and understanding of the key terms and conditions of the products/ services offered / availed.

Shall agree to share complete client data with all RBI approved Credit Bureaus, as per the frequency of data submission prescribed by the Credit Bureaus.

Shall establish dedicated feedback and grievance redressal mechanisms to correct any error and handle/receive complaints speedily and efficiently.

Shall designate an official to handle complaints and/ or note any suggestions from the clients and make his/ her contact numbers easily accessible to clients

10.3 CLIENT PROTECTION GUIDELINES FOR MICROFINANCE INSTITUTIONS

Shall display the Client Protection Code in all branches and offices, in plain view.

Shall endeavor to provide micro finance services to all eligible clients, as per RBI guidelines.

Shall educate clients, staff, and any persons acting on their behalf on the Code of Conduct and its implementation.

Shall disclose all terms and conditions to the client for all products/services offered, prior to disbursement, in any of the following ways:

a) Individual sanction letter
b) Loan card
c) Loan schedule
d) Passbook
e) Through Group/Centre meetings

Shall communicate all the terms and conditions for all products/services in the official regional language or a language understood by clients.

Shall disclose the following terms:

a) Rate of interest on a reducing balance method
b) Processing fee
c) Any other charges or fees howsoever described
d) Total charges recovered for insurance coverage and risks covered

Shall communicate in writing, charges levied for all financial services rendered.

Shall not collect fee on non-credit products/services without prior declaration to the client.

Shall declare all interest and fees payable as an all-inclusive APR and equivalent monthly rate.

Shall follow RBI's guidelines with respect to interest charges and security deposit.

Shall obtain copies of relevant documents from clients, as per standard KYC norms. Additional documents sought must be reasonable and necessary for completing the transaction.

Shall not bundle products, except for credit life, life insurance & live-stock insurance products. The terms of insurance should be transparently conveyed to the customer and must comply with RBI & IRDA norms. Consent of the client must be taken in all cases.

Shall conduct proper due diligence to assess the need and repayment capacity of client before making a loan and must only make loans commensurate with the client's ability to repay.

Shall not be the 3rd lender to a client if the client has loans from 2 other lenders

Shall not breach the total debt limit for any client, as prescribed by the RBI or Central/State Governments.

Shall ensure that all employees follow company guidelines for interaction with clients.

Shall ensure that all staff and persons acting for the MFI or on behalf of the MFI
a) Use courteous language, maintain decorum, and are respectful of cultural sensitivities during all interaction with clients.
b) Do not indulge in any behavior that in any manner that would suggest any kind of threat or violence to clients.
c) Do not contact clients at odd hours, as per the RBI guidelines for loan recovery agents.
d) Do not visit clients at inappropriate occasions such as bereavement, sickness, etc., to collect dues.

Shall provide a valid receipt (in whatever form decided by the MFI) for each and every payment received from the borrower.

Shall follow approved company procedure to deal with client default sensitively.

Shall follow the debt restructuring mechanism adopted by the MFI for borrowers under liquidity stress.

Shall keep personal client information strictly confidential.

Shall disclose client information to a third party only under the following conditions:
a) Client has been informed about such disclosure and permission has been obtained in writing.
b) The party in question has been authorized by the client to obtain client information from the MFI.
c) It is legally required to do so.
d) This practice is customary amongst financial institutions and available for a close group on reciprocal basis.

Shall follow company approved process to raise clients' awareness of the options, choices, and responsibilities vis-à-vis financial products and services available.
Shall inform all new clients about the organization's policies and procedures.
Shall inform clients about the existence and purpose of feedback mechanisms and how to access them.

CHAPTER 11: BUSINESS CORRESPONDENCE MODEL OF MICROFINANCE

11.1 What is "Business Correspondence" Model?

The MFIs are discovering that to become a "Business Correspondent" (BC) of banks is one of most promising possibility of funding the microfinance business in India on a continuous and sustainable basis. In India, the BC model is being tested as one of the most important way to include and integrate the unbanked into mainstream financial services. A BC is an entity that serves as a teller for the bank for which it chooses to act as the intermediary to carry out a range of transactions on behalf of the bank. In return the BC entity is paid fixed commission for the services provided on the disbursements made and collections done on behalf of the bank. Thus, a BC relationship promotes accessible and branchless banking for the banks thereby actually making financial inclusion a reality for the country's poorest citizens.

Any MFI can act as a channel for a bank provided it is not a Non-Banking Finance Company (NBFC). The MFIs can and have started acting as an effective channel for the banks as its field staff has a long standing and trusting relationship with the customers. This all leads to an enabling environment that allows the microfinance customers to feel comfortable in opening savings bank account and depositing money with banks.

11.2 Viability of the BC model

The financial viability of the model still remains a matter of concern as various BCs are struggling to break even. The BC model will continue to remain a costly and people intensive model as the basic concept and methodology of microfinance itself is high cost model. To create a financially sustainable business model in the long haul, it requires high investment in technology and capacity building and also ensuring high levels of efficiency in the field.

A Micro Save study with leading BCs in the country found that at least half of them were struggling to cover their costs and the other half had just started to earn nominal profits. Those in the second category are institutions that strategically and effectively leveraged their existing credit infrastructure to offer the BC savings services and the credit access to the communities served by them. This helped them to keep their fixed costs under control and to build a new source of income on the foundation of the existing one. The BC model is cost intensive in the beginning and needs an initial investment of resources and efforts in capacity building, technology, setting up processes and modifying them to suit the field realities.

To make the BC relationship profitable, the BCs need to recognise the need to offer a range of financial services. The layering of savings services on top of an existing infrastructure for providing credit will not only ensure that marginal costs are incurred which can then be cross-subsidized. As the BC model is typically "a low return high cost" mode, the volumes targeted and reached on the back of efficiency will determine whether an entity is able to achieve profits on a sustainable basis.

11.3 BC can become an effective tool for Financial Inclusion

Typically, the MFIs have the staff; infrastructure, technology and the last mile reach to the clients which banks are mandated to cover in their financial inclusion activities. What the MFIs have been struggling with in the last couple of years is access to regular funding for their microfinance business. The banks, on the other hand, have the funds but not the last mile connectivity and infrastructure to reach these clients. Consequently, both the banks and the MFIs stand to gain from a collaborative effort that can provide the banking services (both savings and credit) to these clients.

11.4 The BC model has benefits for both the banks and the MFIs. Some of the areas where the banks stand to gain include:

a) Access to promote transactions - Although banks have been opening no frill accounts for long, yet they are struggling to service the unbanked segment of the society as they have not been able to promote transactions of any consequence in these low income household accounts. The MFIs can help the banking sector in understanding this segment better and to act as a catalyst of savings and other transactions in these bank accounts.

b) MFIs as cost effective outreach channels – Instead of opening bank branches which can be much more expensive, it might be much cheaper enter into a transaction based commission arrangement with MFIs such that the banks will have access to this unbanked segment at very competitive pricing.

c) Confidence of the Regulator – In the BC relationship the banks have enough say and investment, both in terms of manpower and funds, such that there involvement would be robust enough to satisfy RBI.

11.5 The benefits of the BC model for MFIs are manifold including:

a) **Steady access to funds –** The single most significant benefit for MFIs in any BC model is that regular and hassle free access to fund their microfinance operations becomes a reality. This helps the entity to grow in a sustainable manner, removes the element of uncertainty related to funding and the challenge of sourcing of funds is completely obliterated. The MFI can become BC for different banks in different geographies, thereby enjoying different partnerships and deepening its existing client base.

b) **Risk Mitigation tool for the entity –** When a MFI becomes a BC agent, it de risks the entity in more ways than one. Be it the political uncertainty or the timing and quantum of funds – each one of such risks become nonexistent. The possibility of partnering with different banks also ensures that the MFI is not dependent on just one BC relationship to sustain and broaden its growth in different parts of the country.

c) **Ability to offer a wide range of products to suit the client needs -** As a MFI institution, the entity is restricted from offering a lot of other financial products to the clients like savings, insurance, pension and remittances. As a BC for a bank, an MFI can cater to all of these genuine and varied needs of its existing and prospective customers.

d) **Better and Efficient Cash Management -** As most of the BC relationships make use of card or mobile phone technology on the front end for collections in the field, this also means that the MFIs get empowered to have better and efficient cash management system for their existing business. Typically, 1-3 % of the total cash handled by a MFI remains blocked as cash in hand at its branches thereby posing a challenge of float, idle cash, ineffective utilisation and possible loss by theft, robbery fraud, etc.

11.6 Guidelines by the Reserve Bank of India

Recognizing this potential and the need for banks to access and achieve financial inclusion more rapidly and effectively, RBI has issued various guidelines from time to time under the subject of "*Financial Inclusion by Extension of Banking Services - Use of Business Facilitators and Correspondents"*.

As per the RBI circular DBOD.No.BL.BC. 58/22.01.001/2005-2006, under the "Business Facilitator" model, banks may use intermediaries for services such as:

(i) Identification of borrowers and fitment of activities;

(ii) Collection and preliminary processing of loan applications including verification of primary information/data;

(iii) Creating awareness about savings and other products and education and advice on managing money and debt counseling;

(iv) Processing and submission of applications to banks;

(v) Promotion and nurturing Self Help Groups/ Joint Liability Groups;

(vi) Post-sanction monitoring;

(vii) Monitoring and handholding of Self Help Groups/ Joint Liability Groups/ Credit Groups/ others; and

(viii) Follow-up for recovery.

All of the aforementioned activities are such that can be and are usually undertaken by a MFI as part of their routine and regular business. As these services are not intended to involve the conduct of banking business by Business Facilitators, no approval is required from RBI for using the above intermediaries for facilitation of the services indicated above.

11.7 Entities eligible to become BC for a bank

As per the RBI guidelines, the following entities are eligible for appointment as Business Correspondents (BCs) for banks:

NGOs/ MFIs set up under Societies/ Trust Acts, societies registered under Mutually Aided Cooperative Societies Acts or the Cooperative Societies Acts of States,

Section 25 companies(Ref. Section 8 under Companies Act 2013) that are stand-alone entities or in which NBFCs, banks,

telecom companies and other corporate entities or their holding companies did not have equity holdings in excess of 10 per cent,

post offices ,

retired bank employees,

ex-servicemen ,

retired government employees.

Individual kirana/medical/fair price shop owners

Individual Public Call Office (PCO) operators

Agents of Small Savings Schemes of Government of India/Insurance Companies

Individuals who own petrol pumps

Retired teachers

Authorised functionaries of well-run Self Help Groups (SHGs) linked to banks

Non deposit taking NBFCs (non-banking finance companies) in the nature of

loan companies whose micro finance portfolio is not less than 80 per cent of their loan outstanding in the financially excluded districts as identified by the

Committee on Financial Inclusion

Further, RBI stipulates that in engaging such intermediaries as Business Correspondents, banks should ensure that they are well established, enjoying good reputation and having the confidence of the local people. Banks may give wide publicity in the locality about the intermediary engaged by them as Business Correspondent and take measures to avoid being misrepresented.

For the MFIs, both rural and urban, the BC model holds promise as the current margins at which they are required to operate and the margins which they stand to get in a typical BC relationship would be comparable. The additional benefit to a MFI institution in such a relationship is that they are no longer constrained by the seasonality of funding from banks and other lending institutions. Steady access to funding source, the added credibility and resources of a bank and their own existing infrastructure, trained manpower and access to a large client base makes it a win-win proposition for both the banks and MFIs.

CHAPTER 12: PROCEDURE FOR CASH CREDIT LIMITS FROM MICROFINANCIAL INSTITUTIONS AND TERM LOANS FROM OTHER NBFCs

12.1 PROCEDURE FOR CASH CREDIT LIMITS FROM MICROFINANCIAL INSTITUTIONS

Although many MFIs aspire to secure a working capital loan or a revolving credit from the banks for meeting their funding requirements, getting one is extremely difficult.

There are a couple of disadvantages in this type of financing that act as a deterrent for the bankers like control over the account by the banker becomes difficult and the banker will find it extremely difficult to enforce its claim on the borrower's debtors.

In case of MFIs, book debts or account receivables arises as a result of the lending done to its clients. The micro loans are typically given with a repayment tenure of anywhere between 12- 24 months. The MFI’s available working funds become inadequate to support the scale of operation necessitating an access to bank finance by way of an overdraft against the book debts already created by it out of its equity funding.

One mode of financing microcredit is by way of availing cash credits against book debts. Under this system the bank allows the borrower to draw to the extent of the limit sanctioned to it provided the drawings are secured against adequate receivables.

12.2 BASIC FORMALITIES INVOLVED IN SECURING A CASH CREDIT FROM BANKS

a) Finding a Banking institution which will be willing to provide the Cash Credit/Overdraft facility against book debts:

This first step itself is a very difficult one for the MFIs as most of the banks are willing to extend a term loan of fixed tenure, bullet repayments and fixed/floating interest rate to MFIs but not a overdraft facility against its book debts.

As and when a MFI is able to get the break through on its own or through a fund arranger whereby it gets access to an overdraft facility from a bank against its book debts, that itself is a huge success to celebrate.

b) Calculation of the funding gap which is sought to be fulfilled through the cash credit/overdraft facility:

The MFI seeking such a facility will need to demonstrate by way of financial modeling the gap in funding at regular intervals which is being sought to be covered by the said facility.

The challenge that a MFI usually faces is that the timing of funding from banks and financial institutions tend to be restricted to certain specific time periods (like end of a quarter with no funding usually coming in from banks in the first quarter of a financial year). The borrowing entity has to therefore construct a financial model which gives the various scenarios during any financial year where it will have no funds available despite having good business opportunities in the field. It will need to also demonstrate in the financial model, how the MFI will be able to repay the overdraft facility out of ploughing back of profits and repayments from the clients who are funded out of equity and the overdraft availed from the bank.

The financial projections and the project report will clearly need to demonstrate capital adequacy and availability for providing the book debts/receivables created out of it, which be hypothecated to the bank for availing this cash credit/overdraft facility.

c) Submission of proposal:

A formal proposal will need to be submitted to the bank incorporating the basic information about the company, its current level of operations, its future growth prospects and the resources of repayment.

d) Due Diligence by prospective lender :

Post the preliminary discussion between the lending and borrowing institution, submission of the proposal, a due diligence is usually conducted by the lending institution either on its own or by hiring the services of a professional (chartered accountant in practice).

The due diligence visit usually covers all aspects of the business carried on by the prospective borrower and the authenticity of the assumptions put forth in the proposal in respect of its business cycle and funding requirements.

The due diligence team will invariably meet up with the promoter(s), senior management, Head of Departments. The due diligence also involves visiting the main place of business, namely the registered office, of the borrower and a few of its branches or sales points.

The MFI is required to provide all necessary information and data required by the lender for timely and satisfactory completion of the due diligence process. The entire process can be assigned to chartered accountant firm as part of pre-audit of the entity seeking the cash credit facility.

e) Sanction of Proposal:

Once the due diligence is completed successfully, the financial institution might call for more clarifications, data and information before putting up the proposal internally for approval to its credit committee. The lender approves the requested line of credit with terms and conditions it finds befitting the particular MFI entity.

The Sanction Letter intimating the approval is then sent to the MFI entity, mentioning the terms and conditions for the credit facility sanctioned to it including the % of draw down that would be allowed any given point of time or how it will link to its monthly outstanding balance of receivables.

It also mentions the time period within which the acceptance has to be communicated by the borrower and the tenure within which the execution of documents has to be completed.

f) Acceptance of the Sanctioned line of overdraft facility :

After getting the sanction letter, the MFI institution has to secure an approval from its board of directors to accept and thereafter use this overdraft facility in times of need.

For this purpose, either it has to convene a board meeting or the meeting of its Finance Committee (which is vested with the powers delegated to it by its board members to decide on such matters). A board note is prepared and placed before the committee containing the major terms and conditions of the overdraft facility sanctioned to it by the bank.

Once the sanction letter is accepted by the Finance Committee, MFI then communicates the same to the bank and gets ready to complete the next set of formalities.

g) Execution of documents:

The documents required to be executed between the two parties are then vetted by the legal team and necessary franking of documents are done to complete the execution of documents.

h) Usage of Overdraft Facility:

Advance against book debts is made by way of cash credit or overdraft. The borrower has to submit monthly statements showing the outstanding client wise book debts. The statements so submitted are then scrutinized with reference to the ageing of the book debts and the drawing power as per the agreed terms and conditions.

12.3 <u>TERM LOAN FROM OTHER NBFCS</u>

i Term loans from Financial Institutions to Microfinance Institutions

Despite banks being the preferred source of funding for MFIs due to the lower rate of interest, yet usually it so happens that the smaller sized MFIs have to access most of their funding requirements from NBFCs/financial institutions other than banks.

The banks are not always ready to fund microfinance institutions for

number of reasons including the size of business, background and experience of promoters, business projections, profitability, track record, existing rating and grading of the entity.

The other significant sources of funding for MFIs therefore are other NBFCs who are in the business of lending to MFIs. Although their lending rates are higher than those of the banks, yet these financial institutions play a very important role in case of MFIs which are startups, small in size or do not yet have regular access to funding from the banks.

ii Basic Formalities involved in securing a Term Loan from Financial Institutions

The basic formalities involved in securing a term loan from a financial institution other than a bank, remain almost the same. Couple of formalities specific to banking institutions is not required to be followed in case of availing credit from NBFCs and other financial institutions.

The other distinguishing factor is that the financial institutions take much lesser turnaround time to complete the process of approving and disbursing the loans to MFIs as compared with the banks. If the financial institution gets a positive experience in the first cycle of loan

a) **Preliminary meeting with the financial institution :**

Members of the senior management like Chief Executive Officer, Chief Financial Officer, Commercial Head and/or Finance Head need to meet up the lending team of the NBFC. The MFI will need to put forth a case for the entity's need for funds and also its ability to repay the same. The credit worthiness of the borrowing entity, the profile and experience of promoters and investors, current levels of profitability and future growth prospects are all a matter of discussion and evaluation.

Again this entire activity of pitching the borrower to a prospective lender can either be done by the entity on its own or with the help of fund arranger(s). If a proposal is routed through a fund arranger, they bring on table the advantage of their experience with different lending institutions, their expectations from borrowing entity, negotiating prowess and access to different lending institutions at the same time.

The overall pricing goes up in transactions which are routed through fund arrangers as they will charge separately for their services, the % varying with the quantum and complexity of the deal.

During the preliminary meeting with the lender, the focus from lending team is to evaluate the past track record of profitability, current status of earning profile and future prospects of the prospective borrower. A lot of attention and importance is given to understand the intention, track record and credit worthiness of the promoters and investors. This is the best chance for an entity to build rapport with the prospective lender and build a lasting relationship.

The MFI team should provide a teaser to the credit team of prospective lending institution. This teaser should ideally have content on the nature of business, upcoming projects, business plan, and fund raising needs of the MFI. It always helps to carry a set of Annual Report and the Audited Financials, projected financials & Information Memorandum (IM) as supportive documents.

The discussions should also focus on covering the major aspects of the debt proposal like the type and amount of credit, interest rate, hypothecation and cash collateral percentages and period for which the credit line is being sought

b) Preparation and submission of an Information Memorandum:

An information memorandum needs to be prepared and kept ready

for submission to the financial institution which is being approached either directly or through a fund arranger for availing a line of credit by the MFI.

Either at the time of the preliminary meeting or after its successful closure, the information memorandum needs to be submitted by the MFI.

The information in this particular document can include but not be restricting to the following –

i. Back ground of the MFI
ii. Details about the promoters, investors and senior management team
iii. Current shareholding pattern
iv. Products offered by the entity
v. Geographic presence
vi. Major achievements and Milestones of the entity
vii. Past & Current profitability
viii. Future projections with assumptions
ix. Grading and Rating reports – synopsis

c) Preparation and Submission of Term Loan Proposal:

The term loan proposal is a document which has a lot more data and details as compared with an IM. This is usually prepared in a format which the lending institution stipulates as per their internal requirement for data and information about the MFI seeking the term loan. The proposal usually contains information on the key aspects of the entity like:

i. Incorporation details of the company: Date and Certification of incorporation, date and certification of commencement of business, Registration certificate from RBI to act as a NBFC or NBFC- MFI.
ii. History of the company: its geographical presence, commercial reach and profitability figures.
iii. Details of the shareholders and types of shareholders: No of shares held by various categories of shareholders and Face Value of the shares, various rounds of equity raising done by the entity so far –whether at par or at premium.
iv. Borrowing status: borrowings done so far from other lenders, funding pipeline built against the total funding required by the entity.

v. Credit Monitoring Arrangement Data (CMA Data): it is prepared to determine the borrowing capacity of the MFI entity and has to be submitted by the borrower essentially where the prospective lender is a nationalized bank.
vi. Project Report: it is a report which has the details of project or activity for which the credit is being sought from the bank
vii. Credit rating: A MFI has to get itself rated for the instrument it is looking at for raising funds like debts in the form of term loans and NCDs. The credit rating agencies issue a rating along with rationale which is usually valid for a year with provisions for mid-term review where the entity & rating agency both think that there are major events impacting the profitability and growth prospects materially.
viii. Grading reports: A MFI has to undergo grading exercise which captures the credit worthiness of the entity as a whole vis a vis its peers. Typically the grading ranges from mFR 1 to 8, “1” being the best. The grading reports are valid for a period of one year and banks derive a lot of comfort if the entity is rated anywhere between “1-3” in grading exercise, depending on the size of its business.
ix. Terms and conditions for the line of credit: The proposal also includes the desired interest rate, tenure, securities to be provided against the borrowings.

Once finalized, the proposal is then submitted to the lender along with the other required documents like incorporation certificate, auditor’s financials for last 3 years, rating and grading reports etc.

d) Due Diligence by prospective lender :

Post the preliminary discussion between the lending and borrowing institution, submission of IM and term loan proposal, a due diligence is usually conducted by the lending institution either on its own or by hiring the services of a professional (chartered accountant in practice).

The due diligence visit usually covers all aspects of the business carried on by the prospective borrower. The due diligence team will invariably meet up with the promoter(s), senior management, Head of Departments. The due diligence also involves visiting the main place of business, namely the registered office, of the borrower and a few of its branches or sales points.

The MFI is required to provide all necessary information and data required by the lender for timely and satisfactory completion of the due diligence process.

At times, the lending institution can also choose to appoint a chartered accountant firm to engage in a pre-audit of the entity as part of due diligence.

Usually the senior and middle level management is required to sit with the due diligence team to explain the various activities carried out by their respective teams. The discussions cover a wide range of topics including but not restricted to the business model, product features, commercial and profitability targets, compliance status, risk management or risk mitigating policies, internal and external audit structure, HR policies.

e) Sanction of Proposal:

Once the due diligence is completed successfully, the financial institution might call for more clarifications, data and information before putting up the proposal internally for approval to its credit committee. The entire process of sanction is quite fast as compared with banks and might get completed in a weeks' time at the most.

If there are any specific waivers which the applicant has requested for like not providing the personal guarantee of promoters/investors/directors, then the process of approval might be a multi-pronged process requiring some additional time for the same.

The lender approves the requested line of credit with terms and conditions it finds befitting the particular MFI entity.

The Sanction Letter intimating the approval is then sent to the MFI entity, mentioning the terms and conditions for the sanctioned line of credit. It also mentions the time period within which the acceptance has to be communicated by the borrower and the tenure within which the execution of documents and draw down of funds has to be completed.

f) Acceptance of the Sanctioned line of credit:

After getting the sanction letter, the MFI institution has to secure an approval from its board of directors to accept and draw down the funds.

For this purpose, either it has to convene a board meeting or the meeting of its Finance Committee (which is vested with the powers delegated to it by its board members to decide on such matters). A board note is prepared and placed before the committee containing the major terms and conditions of the sanction given by the bank.

Once the sanctioned line of credit is accepted by the Finance Committee, MFI then accepts the sanctioned line of credit letter and submits the same to lending institution.

g) Execution of Loan documents:

The loan documents are provided by lending institution to borrower, either in soft copy or in hard copy, depending on their internal guidelines and practice.

It is desirable that the MFI seeking the line of credit gets the loan documents vetted by its legal team. This ensures that the loan documents do not have any terms and conditions which would be detrimental to the borrower in the long run.

Post the vetting by legal team, the process of execution of documents is carried out as also the filing of Form No 8 for registration of book debts hypothecation with ROC.

h) Disbursement of funds:

Next step is to get the execution of documents completed with the applicable amount of franking on the documents. The borrower also has to provide the necessary cash collateral in the form of term deposits with stipulated bank. There might be additional pre requisites for disbursal like providing ECS mandate or postdated cheques for the EMI amounts to the lending institution. The disbursal against sanctioned line of credit can happen in one go or in tranches, depending on the agreement between the two parties.

i) Post Disbursal Compliances and formalities:

Post disbursal compliances and requirements include using the funds for on lending to microfinance clients, creation of book debts within the stipulated time period (30 – 45 days) and hypothecation thereof to the lending institution. At times, there is also a post disbursal audit or inspection which is done either by the bank officials or a chartered accountant firm hired by the bank.

“End use certification” of the funds is also a usual post disbursal requirement. This ensures that the borrowing institution has not used the funds taken from the lending institution for any other reason other than on lending to its clients.

This is to be issued either by the statutory auditor of the borrowing institution or an independent chartered accountant firm.

CHAPTER 13: <u>CONSTRAINS OF MICRO FINANCE</u>

Taking out loans, buying insurance, and saving money all teach people how to be future oriented. Instead of living day to day, they have to think about their lives into the future, plan for the future, make sacrifices in anticipation of a better future, and work toward improved lives. This is the essence of capitalism. It is worth noting that development agencies that have historically had mixed feelings about capitalism are devoted to teaching small-scale capitalism through micro finance.

Micro credit loans are expensive. Interest rates charged by micro finance programs are often over 20%. They have to be, because overhead is high for administering tiny loans. That means it's hard for borrowers to make enough profit to really get ahead, after they pay loan costs. From this study it can find that poor people to start with what resources they have or they have to borrow interest-free from family members

13.1 <u>Risk Rise in Credit and Funding:</u>

There is also concern that recession will expose "naked swimmers: weak MFIs with poor funding and inefficient management who were being buoyed by good economic conditions and overabundant funding. The risk of institutional failure is seen to be High Many respondents saw a vicious circle. Here, the recession creating a worse business environment, leading to mounting delinquencies and shrinking markets, leading to declining profitability, leading to loss of investor confidence, leading to cutbacks in funding, and so on.

13.2 <u>Risk in MFIs of Asian Countries:</u>

The Asian response was strongly tilted towards practitioners who saw the biggest challenges lying in the area of management, particularly corporate governance, technology and staffing. Their concern about the impact of the economic crisis was more muted: liquidity risk and credit risk concerns appeared in their top ten, but not in the concentrated form of other groups. Concerns about the standing of micro finance also showed up strongly in the high place given to the risk of mission drift and unrealizable expectations. Political interference is another big issue, particularly in India. The intensity of risk to the MFIs of Asian countries were prescribes as following manor on the basis of the study.

[I] Higher Rate of Risks:

1 Liquidity,

2 Corporate governance,

3 Management quality,

4 Competition,

5 Credit risk,

6 Managing technology,

7 Staffing,

8 Political interference,

9 Mission drift,

10 Refinancing.

[II] Rapidly Risers:

1 Competition,

2 Credit risk,

3 Mission drift,

4 Political interference,

5 Macro-economic trends,

6 Interest rates,

7 Liquidity,

8 Unrealizable expectations,

9 Fraud,

10 Too little funding.

13.3 Type of Risk of MFIs in Practices:

1. **Management quality:** Concern about the quality of management in MFIs has eased from the No. 1 position it occupied in the second round of the study. This is partly because it has been overtaken by more urgent risks created by the economic crisis, but also because there does seem to have been progress.

2. Corporate Governance :

With management quality, concerns about the strength of corporate governance in MFIs have been overtaken by more urgent considerations, hence the fall of this Banana Skin in the rankings. But it has not gone away. The responses suggested that corporate governance remains a challenge for MFIs in many parts of the world, particularly in this period of stress, and is widely viewed as a central long term issue.

3. Inappropriate regulation:

This is a risk that comes in many forms. Depending on whom you are and where you are, there is either too much regulation or too little, it is either ineffective or oppressive.

4. Efficiency of Staff:

One reason could be that the huge amount of resource that has been applied to staffing is beginning to pay off. Second is that the recession has eased staff shortages, and a third is that MFIs who transform themselves into banks are often able to offer more interesting and better paid jobs.

5. Rate of Interest:

Interest rate risk is seen to have fallen quite sharply, mainly because the earlier volatility has eased, and rates are generally much lower. But the difficult economic environment could expose MFIs to unfamiliar challenges on this front.

6 Competition:

It is reflecting the changed conditions brought on by the economic crisis. Many respondents felt that competition, particularly the entry of well-heeled commercial banks into the market that banks which had entered the market "lack the proper methodology to deal with credit financial services to poor micro entrepreneurs. This can be seen in the growing indebtedness of small customers.

7. Strategy and Technique Management:

This is one of those long-term, strategic risks that have been brushed aside by more urgent concerns about the economic crisis.

8. Political Interference:

As for types of respondents, concern was higher among investors than practitioners. Deposit-taking MFIs expressed little concern, suggesting that this risk lies more on the lending side. Political interference takes many forms: directed lending, interest rate caps, loan forgiveness, and subsidized competition. The two most frequently mentioned by practitioners were asset grabs in countries where MFIs were well-resourced, and controls on the cost and availability of loans. An industry analyst said that technology is "not evenly present in the industry, and smaller MFIs with few economies of scale will find it difficult to keep up with new applications, given costs.

9. Credit risk:

In the past, credit risk was seen as a minor problem in a business whose typical customers had an excellent repayment record, but not any more. A combination of stressful economic conditions and structural change within the micro finance (MF) industry has greatly increased concern about default and loan loss.

10. Transparency:

Concern about poor transparency in the MF industry has fallen, reflecting some improvement on this front, often under pressure from investors and rating agencies who want better information and accountability.

11. Foreign Exchange

Foreign exchange risk is rising because turmoil in financial markets has exposed weaknesses in the micro finance investment model. For years, investors have been investing in MFs with hard currency – mainly dollars to fund loans which are disbursed in local currency.

12. Expectations 0.from MFIs:

Practitioners and investors shared the view that this was a middling risk with the broad feeling being that MFIs was bound to create disappointment: it was a question of managing expectations.

13. Mission drift:

There is the ongoing dilemma over the micro finance balance between business and philanthropy, but the new concern is that the economic crisis could tilt the balance towards commercial survival. Most respondents saw this as a rising risk.

14. Fraud:

Many respondents made the point that a downturn and fraud go hand in hand. However, a declining economy typically yields small scale financial fraud (lying on applications, falsifying income sources, lying on insurance claims, etc.). This small scale fraud has a potential to hurt micro finance institutions.

15. Reputation:

The MF industry has a good reputation in broad terms. But the responses threw by respondents up to several worries. One is that the growing commercialization of the business will draw it away from its social goals and earn it a bad name. Leading on from this, another is that MF will be “exposed by an unsympathetic Press as having failed to improve the lot of its target communities. A third is that the recession will force MFIs to be tougher on their customers and attract bad publicity.

16. Liquidity:

Like credit risk, liquidity risk has risen dramatically. It has be seen as one of the most significant risks to the MFIs.

17. Macro-Economic Trends at Micro Level:

The global economic crisis is seen to pose a high risk for micro finance, despite the conventional wisdom that MFIs inhabit their own business world. Many respondents said that MFIs could no longer claim to be insulated from shocks in the “real economy: there are too many links through financial markets, credit conditions and the fortunes of their customers.

18. Refinancing:

.Refinancing risk addresses the danger that MFIs may not be able to renew their base funding from investors or donors because of changes in their circumstances or – currently – owing to the stresses of the economic crisis.

19. Crisis of Profit:

The matter of Profit is also critical for outcome from crisis. Profitability are rising, as an expected situation may arise in different types of economic condition. Though from a low

level which reflected the earlier view that MF is more about philanthropy than making money.

20: Limited funding:

The economic crisis has turned the issue of funding on its head. The MFI sector was being swamped by indiscriminate funding which was leading to excess capacity, dangerous levels of competition and the risk of disappointment. The problem of too little funding was considered minimal. This time, the fear is that the economic crisis will cause funding to dry up.

CHAPTER 14: SMALL ENTERPRISE DEVELOPMENT AND MICROENTERPRENUERS

In the current political and economic environment, jobs are at the center of political debates in both developed and developing economies. There are many expectations that small enterprises can create new jobs, although may a times small enterprises contribute more to the employment share in low-income economies than in high-income countries

The track record of MFIs serving small businesses is mixed, and providers should not add this new segment to their microbusiness without acquiring new data, capacity, and tools. MFIs are increasingly interested and aware of the need to improve their capacity to serve the small business market. Also, many networks and funders, private and public, are interested in helping MFIs improve their readiness to serve small enterprises.

14.1 Microenterprise

Dictionary meaning of microenterprise is “very small-scale business, esp. owner-operated with few employees” .The term “microenterprise” refers to a very small-scale, informally organized business activity undertaken by poor people.

14.2 Microfinance

Asian Development bank defines Microfinance as the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and, their microenterprises. Ledgerwood defines microfinance as “The provision of financial services (like savings, credit, insurance and payment services) to low-income clients (the poor), including the self-employed”

14.3 <u>How Do MFIs Meet the Needs of Small Enterprises?</u>

MFIs are increasingly serving small businesses Many financial service providers serve small enterprises in, including commercial banks, cooperatives, MFIs, and others. These providers have different capacities and motivations, and target different specific subsegments within the small business landscape. Larger financial service providers, including commercial banks that want to serve small businesses, tend to focus on firms that are larger and formal. On the other hand, MFIs usually focus on enterprises that are smaller and often informal. Most MFIs are looking at small enterprise segments because they offer additional business growth opportunities, Another motivation is the MFIs’ desire to continue serving a small number of growing microclients

14.4 <u>Understanding the Financial needs of Small Enterprises</u>

Defining small enterprises is challenging. Most definitions use criteria such as the number of employees, net assets, or sales. However, different countries have adopts different meaning Small Enterprises. Their main characteristics include the following: employees, typically family-owned, they often have fixed assets and a fixed place of business, in contrast to many microenterprises. Ownership and management are mostly the same with simple financial recordkeeping, often separate for the business and household, their capital base is often small; while starting capital is generally provided from their own savings and borrowings from relatives and friends

The underlying challenge many MFIs face when attempting to establish small business lending operations is that this segment consists of an extremely heterogeneous group, Hence, a more sophisticated approach to customer service and risk assessment is often needed to serve these businesses adequately and to control credit risk, long-term debt, current accounts, transfers, and payments. For example, long-term debt finance is one of the most commonly cited needs of small enterprises. Small businesses also have many nonfinancial needs that are often unmet

14.5 Three Reasons why MFIs are Interested in Serving Small Businesses

i Understand the market.

Small businesses have unique needs, typically different from larger companies, but often different from one another. MFIs need to invest in getting to know this new target group well and employ specific tailored approaches. MFIs will need to conduct market studies, mine available data to learn from their current portfolio or conduct primary research, and use direct observation. A deep understanding of customer needs and market demands is critical to the segmentation process.

ii Engage in an institution-building process.

Opting to provide financial services to small businesses is a strategic decision that should be made at the highest level of management. Hence, it requires managerial commitment to the process of introducing a new business line and careful planning. It can entail creating a dedicated small business unit separate from the microfinance department. However, smaller institutions or those that do not cover the wider spectrum of enterprises can have simpler structures that do not include separate units exclusively for small business lending. In any case, the MFI needs to ensure that microfinance officers who are to become small business officers are trained with a thorough understanding of the differences between the two market segments and products offered.

iii Develop tailored risk assessment methods.

Small business loans involve larger amounts and greater complexity, so risk assessment requires thorough analysis, due diligence, and number crunching. Credit rating and scoring tools can help MFIs manage the risk better, though they face a challenge where large samples are not available to construct a model. Therefore, financial institutions that are new to the small business lending market may not have the data needed to develop a sound credit scoring system. More often, financial institutions tend to apply modified scoring systems where they use the experience gained on the ground to develop a quick set of loan assessment parameters for different groups of loans.

The MFI will also need to develop specific training for loan officers, moving from a “character only” lending judgment, as used for many microfinance lending decisions, to one that highlights first cash flow and second collateral or guarantor forms of repayment when making a small business lending decision.

14.6 MFIs’ challenges in serving small business

Moving from the micromarket into the small business market requires different staff capacities, management systems, and risk assessment tools. Lack of appropriate risk assessment methodologies Many institutions do not have separate methodologies for micro and small enterprise risk assessment. Most of these institutions use their existing microfinance risk assessment tools for small business clients despite the fact that a different level of client analysis, including financial analysis, might be required. The lack of appropriate mechanisms to manage risks seems to have important implications for MFIs that are trying to expand to small business markets.

14.7 Inadequate MFI products

Most MFIs offer standard short-term credit to their core microclientele. However, small businesses often need other products that many MFIs do not currently offer. , institutions that wish to retain their business clients in the long term will have to find solutions that will enable them to cater to the changing needs of these clients over time. Alternatively, MFIs may make the strategic decision to focus on a specific small business segment or to target only small businesses up to a certain size and with limited needs in terms of financial services

14.8 Lack of a specialized department and staff

Specialized staff or a dedicated department would seem essential to serving small businesses successfully. This is a common feature among mainstream commercial banks that are leaders in the small business market.

14.9 Weak portfolio management and data analysis

Sustainable services to small businesses require good MIS, but many MFIs are still lagging behind in this aspect. A large number of MFIs do not monitor their small business portfolio separately from their microfinance portfolio, which limits their ability to manage these portfolios. Another challenge is that MFIs often have to create or reconstruct the basic financial records of small portion of their revenues for tax purposes. Some MFIs are dealing with this challenge by streamlining the underwriting processes and forms, focusing only on important elements of evaluating a small business, such as form of repayment (cash flow), form of guarantee (collateral or guarantor)

CHAPTER 15: SUPPORTING WOMEN IN THE INFORMAL SECTOR

Women as micro and small entrepreneurs have increasingly become a key target group for micro-finance programmes. Providing access to micro-finance is considered a precondition for poverty alleviation, but also for women's empowerment. As poor women are increasingly recognized to be better borrowers, they are starting to become of interest also to regular financial institutions. But despite the proven positive impact of providing microfinance services to female entrepreneurs in the informal sector, microfinance is just one tool among others to address the multiple causes of poverty, unemployment and social exclusion.

Women tend to make up the greatest portion of the informal sector, often ending up in the most erratic and corrupt segments of the sector .The reasoning behind why women make up majority of the informal sector is two-fold. Firstly, it could be attributed to the fact that employment in the informal sector is the source of employment that is most readily available to women. A vast majority of women are employed from their homes or are street vendors, which both are classified in the informal sector. Furthermore, men tend to be overrepresented in the top segment of the sector and women overpopulate the bottom segment. For example, very few women are employers who hire others and more women are likely to be involved in smaller scale operations. Labour markets, household decisions, and states all propagate this gender inequality

15.1 Women as micro entrepreneurs in the informal sector

In many developing countries, and lately increasingly so in many industrialized countries, the vast scale and rate of growth of the informal sector presents a dilemma and a challenge for governments, social partners and the civil society alike. A dilemma, as the informal sector encompasses employment situations which not only differ from those in the formal sector, but also infringe upon established rules and laws. A challenge, as it absorbs a large and growing fraction of the labour force, and provides a "safety net" for the poor, finding themselves excluded from formal employment and income opportunities.

While the slow, or even negative, growth of formal sector employment opportunities, combined with a rapid and significant growth in the urban labour force, economic stabilization and restructuring programmes, and the quest for increased flexibility and deregulation of the economy have had detrimental effects on men and women alike, women have been increasingly pushed into informal activities. For example, the reduction in public sector jobs has affected women more than men, because of their concentration in temporary and lower level jobs; the decline in formal sector wages, has forced many women to turn to renumerated, most often informal work; attitudes and cultural norms constitute other powerful barriers to women's entry into the (formal) labour market.

Since the women as micro and small entrepreneurs have received increased attention and assistance by governments, international donors and NGOs. Microenterprises have been seen as having particular advantages for women: e.g. their flexibility and location in or near women's homes, ease of entry and links with the local markets. Supporting their entrepreneurship is seen as having important "trickle down" effects on wider poverty alleviation and gender inequality. Female entrepreneurs have been given particular characteristics, developed partly as strategies to overcome economic and other discriminations:

- the use and investment in social networks;
- a greater reluctance to take risks; and
- a tendency to diversify in order to minimize risks.

With the growing role of female microentrepreneurs, women will need to rely on the success of these strategies, looking at the constraints they face:

- lack of access to productive resources due to discriminations in property ownership and in employment;
- lack of time because of unequal gender division of labour in unpaid productive and reproductive activities;
- lack of skills due to lower levels of literacy and formal education;
- lack of access to labour as a result of norms of gender hierarchy and separation; and
- lack of access to markets due to their exclusion from the most lucrative markets.

With informal sources of finance being relatively easy to access, women rely on moneylenders, rotating savings, and friends, relatives, suppliers and shopkeepers. While these sources are providing the bulk of financial resources for female entrepreneurs and offer a number of potential advantages, such as proximity between borrower and lender, immediacy of loan disbursement, small loan size, flexible repayment schedules and minimal collateral requirements, they can be costly and discriminatory.

Formal financial institutions are even less receptive and welcoming to female entrepreneurs. Their collateral requirements, bureaucratic loan application, disbursement procedures, the time and resources necessary to visit the banks and discriminatory banking culture virtually exclude poor women as clients.

The provision of sustainable access to financial services for women has therefore become a core component of many women's microenterprise programmes, and is at the center of the attention of governments, social partners, civil society organizations and international donors.

15.2 <u>Providing women entrepreneurs with sustainable access to microfinance</u>

It provides women micro-entrepreneurs with access to financial services are extremely diverse, offering alternatives to the formal banking system, while incorporating the advantages of informal savings and credit systems. The features that most programmes have in common are:

- close targeting of the most needy borrowers;

- decentralised loan delivery and management systems through intermediary institutions or parallel banking system;

- group formation to ensure financial discipline; and

- support systems to enhance productivity.

i **Social programmes** run by commercial banks, which provide borrowers with incentives from the government .Most commercial bank schemes have failed to reach large numbers of poor borrowers, let alone women.

ii Intermediary programmes, generally run by NGOs offering micro-businesses a link to the formal banking system. Most programmes have succeeded in reaching somewhat better-off women.

iii Parallel programmes that provide financial services alongside other development and social programmes via non-bank institutions. Many of these programmes have succeeded in reaching women clients, heavily supported by donors.

iv Poverty-oriented development banks, generally started as intermediary or parallel programmes and then officially registered as banks (for example: SEWA Bank, India; Grameen Bank, Bangladesh). They have adapted delivery systems and loan conditions to meet the specific needs of female clients.

v Community revolving loan funds, With government and donor grants or loans. These funds offer limited but useful services to women. If well managed, they can be sustainable. The major risk is erosion of funds due to default and inflation.

vi Savings and credit cooperatives and unions providing special schemes for women members .Participatory methods help ensure that these organizations meet the real needs of members. They mobilize their own capital and are more or less democratic. Cooperatives can, however, be formalistic and financial services are not always readily available.

Women have become the preferred clients of microfinance institutions, as they tend to be better borrowers.

Successful microfinance institutions are characterized, besides using "collateral substitutes",

- offering primarily short-term working-capital loans;

- having a turnaround time for loan approval of less than 2 weeks;

- providing services close to borrowers' home or work;

- charging interest rates significantly above the rate of inflation, and

- having lower salary levels than financially less viable programmes.

Interestingly enough, there does not seem to be a trade-off between reaching the very poor, and primarily women, and reaching large numbers of people. It seems to be scale, and not an exclusive focus, that determines whether significant outreach to the poorest occurs.

vii Impact of microfinance on women micro entrepreneurs

It is widely assumed that micro-finance will have a positive impact on women's livelihood in i) leading to higher income that will help women to better perform their reproductive role as brokers of the health, nutritional, and educational status of other household members, ii) increasing women's employment in micro enterprises and in improving the productivity of women's income-generating activities, and iii) enhancing their self-confidence and status within the family as independent producers and providers of valuable cash resources to the household economy.

The plausibility of these assumptions is largely borne out by empirical evidence. Impact assessments provide evidence of the positive effects of micro-finance on the livelihood of poor women, especially in *Asia*:

- It started from Bangladesh which confirms improvements in women's physical mobility, economic security, ability to make own purchases, freedom from family domination and violence, political and legal awareness and public participation, as a result of a more stable integration into microfinance circuits

- Grameen Bank suggests that women participants in credit programmes are more conscious of their rights, better able to resolve conflicts, and have more control over decision making at the household and community levels
- credit to women has positive effects on the schooling of girls, it increases women's asset holdings and is a significant determinant of total household expenditure

viii Access to and control over financial resources -- the emerging debate

Women's control over financial resources is increasingly seen as a key factor in explaining the mixed results. While only a limited number of impact assessments exist that focus on this issue, the available evidence highlights that a significant part of women, who may have ***access*** to finance, may not have ***control*** over the loans contracted

- When women loose control over the use of their loans, their overall status in the household may improve due to their role as a financial mediator;

- Handing over loans to men may help to secure family stability by easing cashflow bottlenecks in the household;

- Women may also use credit as a bargaining chip to gain access to other opportunities offered by financial institutions, such as training, education and information.

However, it seems obvious that the impact of micro-finance services is higher when women actually control the financial resources acquired in their name. to contribute to women's empowerment;

- to facilitate women's entrepreneurship;

- to assist women in their reproductive tasks;

- to ease their repayment burden.

The discrepancy between nominal borrower status and effective control over loan transactions is also partly due to donor behaviour.

- A shift of refinancing from microfinance organizations that emphasize women's social development and empowerment to others placing a premium on early and full financial sustainability

- Cutting back on support services, such business management, skills training and education and information provision in order to cover costs.
- pushing for bigger and more loans.

- Using women as unpaid debt collectors that facilitate intermediation between micro-finance institutions and male family members thereby reducing lenders' transaction costs.

However, it could also be argued that in the long term, the insistence on financial sustainability may contribute to a 'more efficient and continuous supply of financial services that allow women micro entrepreneurs to take advantage of economic opportunities.

CHAPTER 16: <u>MICRO FINANCE INSTITUION DUE DILIGENCE-GUIDE ON REVIEW OF MICROCREDIT PORTFOLIO</u>

Microfinance institutions (MFIs) operate with risks that investors need to be concerned about. Unfortunately, external audits, ratings, evaluations, and be concerned about. Unfortunately, external audits, ratings, evaluations, and even supervision too often fail to identify the primary risk—inaccurate representation of portfolio quality. These due diligence guidelines are designed to help an analyst evaluate, with statistical precision, the accuracy of accounting and performance reports about the portfolio, as well as an MFI's compliance with its own portfolio management policies.

16.1 THE DUE DILIGENCE PROCESS

Due diligence is the process of examining a company's performance. It is typically performed by or on behalf of investors who are primarily interested in verifying that performance is accurately reflected in the financial statements and company reports, and that management and operating systems are robust enough to sustain good performance into the future In the commercial financial industry, investors rely heavily on external appraisals of a financial institution to analyze performance trends. Audits, ratings reports, stock analyst reports, supervisory reports, and even media articles provide an array of appraisals of a financial institution's performance. This varied and ongoing measurement of performance provides incentive to the financial institutions, creates consensus around best practice metrics, and provides an evaluator with many sources of analysis. Thus the due diligence analyst typically arrives at a financial institution with considerable information.

A due diligence process that incorporates all three tiers offers the greatest precision and highest degree of certainty about the actual level of loan portfolio risk.

Tier I. This is a five-day review of the MFI's basic policies, procedures, and systems for managing and reporting on its loan portfolio. It is both a high-level analytical review of portfolio trends and a stock-taking exercise. In the stock-taking exercise, the analyst collects the MFI's full inventory of credit policies, procedural manuals, key accounting policies and financials. The Tier I assessment is based largely on the completeness and coherence of this inventory and on interviews with management about portfolio trends and the policies, procedures, and systems for managing the loan portfolio.

Tier II. This is a 10–14 day assessment of whether MFI operational practices are consistent with policies and procedures and with standards of best practice in microcredit portfolio management. The analyst verifies that accounting policies and reporting formats are consistent and based on sound practices; that credit department staff conduct operations according to policy and procedural guidelines; and that the MFI does not regularly engage in practices that generate unmeasured credit risk, such as reclassifying of loans, refinancing and granting parallel loans.

Tier III. This is a 3–4 week exercise that includes detailed testing of transactions to confirm the portfolio quality through a sampling of loan files, accounting files, and the loan tracking management information system (MIS). The Tier III audit uses statistical sampling methods that support conclusions, within acceptable levels of confidence and error, about real arrears levels and, more broadly, the risks related to accounting practices and credit policy. The Tier III conclusions are supported by the results of the audit—namely, whether portfolio performance is accurately reflected in accounting and performance monitoring reports.

16.2 TIER I DUE DILIGENCE

Tier I due diligence encompasses what should be the first step in any assessment of an MFI's performance, credit operations, and accounting practices. The primary objective of this review is to determine if the MFI has adequate policies, operating systems, monitoring, and management capacity to sustain portfolio quality. The analyst will collect documents and reports, conduct a basic review, and interview top management about the basic business model of the MFI and recent trends. This assessment should not require more than two days in the head office, plus preparation time of approximately three days

The Tier I process will typically consist of four steps:

- Gather information before the field visit.
- Conduct a desk review.
- Conduct a field visit.
- Prepare the final analysis.

Information Requirements

The process of gathering information is the lengthiest step in Tier I, and it will provide the analyst with important clues about the capacity of the MFI to manage its portfolio operations.

i Financial reports

• Audited financial statements for the past two complete fiscal year. The audited financial statements report should consist of an auditor's opinion, financial statements, and notes to the financial statements. The analyst should ask for the complete report, including the management letter if the auditor provided one, and the MFI management's response to the auditor's report Current year-to-date financial statements if more than one quarter has elapsed

• Supporting internal financial reports for the same periods that provide sufficient detail of the loan portfolio (classification by risk/reserve categories), reserves, income, and expenses

• Current liquidity and asset and liability management report

Accounting policies. This will consist of an accounting policy manual and memos related to the following transactions:

• Accounting of loan balances by arrears classification

• Rescheduled loans

• Loan loss provisions, loan loss provision expenses, loan write-offs, and recoveries

• Fee and interest income on loans, including the accrual of interest

• Allocation of client payments to outstanding balances

• Liquidation of collateral

• Any noncash methods of loan repayment

ii Portfolio reports.

The loan portfolio reports are typically produced by the MFI's management information system (MIS) and provide detailed information about lending activities. The MIS should be able to produce the following reports for the analyst:

• Portfolio classification of loans and amounts by number of days delinquent

• Comparison of actual loan repayments to scheduled repayments

• Breakdown of portfolio by loan product including number of active loans, total portfolio, and portfolio quality for each category

• Portfolio reports by branchand/or loan

• Detailed reports onrestructured and refinanced loans

• Summary portfolio performance reports for branch managers, senior management, and board of directors

iii Assessments, appraisals, and external evaluations

The MFI should send the analyst the report generated by any assessment, appraisal, or external evaluation that has been done during the two previous years. This information is generally confidential and should be treated as such by the analyst. Increasing numbers of these reports are being prepared by ratings agencies for affiliate networks, donors, and investors.

iv Desk Review

The analyst should prepare for the site visit with a desk review organized around 3 objectives

1-Understanding of the business model and operations of the MFI, including the most recent growth, provisioning, and write-off trends. This will guide the analyst's interviews with senior management. The analyst should also discuss any major changes in the market or in MFI operations and determine how these might affect portfolio management.

2-To determine if the MFI has adequately documented policies, procedural manuals, and financial and portfolio performance reporting. The ability of the MFI to provide these documents is the first indication of the management capacity and professionalism of the institution. Anything short of immediate delivery of a complete set of documents and reports should guide the analyst toward areas that require special attention during the field visit

3- Desk review is to identify policies or performance that deviate substantially from best practices of similar MFIs

v The Field Visit

The field visit provides the analyst with an opportunity to gather missing information and ask clarifying questions, to check for consistency between MFI policy and management's understanding of those policies, and ultimately to form an opinion about senior management capacity.

vi Final Analysis

The analyst needs to form an overall impression of the MFI's portfolio risk Much of this impression depends on the analyst's confidence about the trustworthiness of the information and the senior management team. The analyst

should consider the following:

• Transparency of data

• Ease with which data ,are provided

• Top managers' familiarity with loan portfolio quality indicators and reports

• Consistency of information across several MIS reports

• Staff commitment to ironing out inconsistencies

• General environment of orderliness and internal control

• Presence of actual ex-post control mechanisms

• Clarity in all aspects of theMFI's operation

16.3 TIER II DUE DILIGENCE

Tier II due diligence builds on the Tier I exercise .After completing all of the tasks for Tier I, the analyst completes five additional areas of analysis:

• Integrity and completeness of the MIS

• Verification of loan classification, provisioning, and write-off procedures

• Actual performance of credit operations, especially in branch offices

• Degree to which the work of individual loan officers reflects MFI policy

• Integrity and completeness of individual loan files

i MIS Review

In Tier II due diligence, the analyst will focus on verifying the accuracy of reports and the capabilities of the accounting and portfolio tracking systems. The Tier I review will likely guide the analyst toward the areas of these systems that merit further study. A lack of clarity around accounting practices, or discrepancies among reports, provide important clues for further investigation.

ii Loan Classification, Provisioning, and Write-offs

The Tier II analysis should evaluate the MFI's method for classifying its portfolio, estimating and provisioning for loan losses, and writing off and recovering bad loans. The evaluation should compare real losses to provisioning g levels. For most MFIs, the risk classification system should be based on repayment performance as well as historical patterns associated with factors such as specific lending products, guarantee coverage, economic sectors, geographic location, and branch office. MFIs with finely tuned classification criteria use classifications not only for provisioning but also to set differential risk-based interest rates

iii Branch Office Management

This part of the Tier II exercise focuses on how well the MFI manages credit operations through the branch offices. Most of the information for this analysis is gathered through interviews with credit department management and branch office staff. The analyst should structure the analysis around five basic areas.

iv Distribution of authority and responsibility.

The analyst should map how the key credit activities and decisions are organized between headquarters and the branch offices. Ultimately, the analyst will be looking for an appropriate e balance of operational efficiency and control in the MFI's management of lending targets, loan approvals, cash management, accounting, and reporting.

v Performance management

The analyst should pay special attention to how branch office performance is managed. The mapping exercise should reveal how responsibility is distributed for setting performance targets, gathering performance indicators, performance reporting, performance review, and management response to performance achievements. The analyst should expect to find robust systems for measuring performance and decisive management response to both good and poor results.

vi Loan Officer Performance

Loan officers are one of the most important sources of information about lending operations. They carry out most of the procedures, and they are closest to the clients. The analysts should expect to spend at least three full days with the loan officers, away from senior management, to capture the reality of field operations. The analyst should use informal conversations with loan officers to cover the topics of portfolio quality, how closely lending policies are followed, how flexible they are, routine contact with current clients, loan rescheduling/refinancing, and delinquent loan procedures Analyst should be careful how they question loan officers to avoid intimidating field staff and impeding the discussions .Analysts should also accompany loan officers on client visits to witness first-hand how procedures are followed in the field. On these visits, analysts should be able to get a sense of the client’s history with the MFI, level of satisfaction, relationship with loan officer, and so forth. Discussions with clients should be brief and unstructured with a few open-ended questions. The analyst should also review the MFI’s training program for credit officers and any incentive systems to encourage good performance. Incentive systems should be based primarily on portfolio quality. Incentive systems that reward portfolio growth without quality will undermine rigor in loan selection and eventually portfolio performance.

vii Final Analysis

Like the Tier I analysis, the Tier II analysis will be guided by judgment. However, the Tier II exercise will provide the analyst with a wide range of opportunities to evaluate whether the MFI conducts business according to its policies as well as to observe signs of success or failure. Ultimately, the analyst should be able to present a well-formed opinion about the core performance areas, substantiated by observation and analysis.

16.4 TIER 3 DUE DILIGENCE

Tier III due diligence aims to achieve a quantifiable level of certainty regarding the quality of the loan portfolio that would satisfy a commercial investor. The exercise uses statistical methods to verify individual account balances, measure the level of compliance with lending policies and procedures, and check for material discrepancies and fraud.

The exercise will enable the analyst to answer three basic questions with statistical certainty:

• Do the portfolio tracking and accounting systems accurately reflect loan balances, transaction activity, and portfolio risk?

• Does the MFI rigorously follow sound lending policies and procedures

15 Does the MFI have adequate systems of internal control to ensure robust performance monitoring and compliance with policies and procedures?

i Audit Scope

Analysts define the scope of the Tier III audit based on their assessment of the Tier II results. Specifically, analysts must use judgment to determine which reports, accounting policies, and loan management procedures have significant impact on the risk of portfolio performance, and then identify the specific data to audit. These decisions will likely require some modifications to the scope and organization of the MIS and procedural audit templates used in Tier II. At a minimum, the Tier III MIS audit will go further than the Tier II exercise by confirming the payment vouchers and general ledger entries associated with each of the disbursements and payments that appear in the loan tracking system.

• For each sample loan, compare the disbursements and payments that appear on the loan summary report with the accounting vouchers that support actual disbursements and payments. Take note especially of how payments are made (cash, check, post-dated check, new loan, repossession of collateral, other).

• Follow each of these payments through to the general ledger, and check compliance with the MFI's policies for recording interest and principal amounts, and policies for noncash payments.

ii The Tier III Sampling Method

The Tier III sampling methodology is designed to provide levels of certainty that are adequate for most investors or regulators to make decisions, without incurring the enormous costs required to achieve high levels of certainty about the precise value of the portfolio. The primary objective of this sampling method is to validate the findings of the Tier II exercise. Specifically, the analyst will weigh the sample to test the areas of high risk detected during the Tier II analysis. This added level of statistical certainty makes Tier III conclusions uniquely robust.

iii Final Discussion with Management

At this stage of the Tier III exercise, the analyst will formulate preliminary conclusions about the overall performance of the MFI, loan management, the integrity of policies and procedures, and the accuracy of the portfolio reporting and accounting systems. The final step in the investigation phase is to present these tentative conclusions to MFI management for discussion.

The final consultation with management serves at least three purposes. First, it engages management in the final interpretation and this helps generate management buy-in to the final report and recommendations. Second, it gives management an opportunity to correct misconceptions and provide perspective that adds important nuance to the final interpretation. Finally, the discussion gives the analyst a final look at management capacity and attitude.

CHAPTER 17: ANALYSIS OF MICROFINANCE BILL 2011 AND 2012

17.1 BRIEF ABOUT SECTIONS

i. **Preamble:** Provides for regulation of micro finance institutions providing micro finance services, such as micro credit facilities, thrift, pension or insurance services and remittance of funds and prohibit micro finance institutions from carrying on the activities of micro finance services without registration with the Reserve Bank.

Sec -2(1) (i) Provides for all forms of MFIs to be registered under the Act and further the services of microfinance

ii. **Existing NBFCs registered under the Reserve Bank of India Act, 1934 are allowed to continue such services even without registration** under this Act. Clearly NBFCs have the option to register under the new Act **(Sec -2(1) (i) (B))** or to continue with RBI under the existing regulatory structure **(Sec -14(2))** further clarity obtained from the Statement of Objects and Reasons -4(a) .But it is interpreted that NBFCs willing to continue under the present regulatory framework may find it difficult to offer thrift services.
The NOF for this Act has been maintained at Rs 5 lakhs or such other higher amounts as may be specified by regulation. The RBI has a power to specify a higher amount of NOF under Sec 50 (2)(e)

iii. **Sec-2(1)(j)(A):** Micro credit is defined as credit facilities involving such amount, not exceeding in aggregate five lakh rupees for each individual and for such special purposes, not exceeding ten lakh rupee.

This is in quite contrary from the extant regulation of RBI. From our discussion with the MOF it is understood that the Law ministry was of the view that Rs 50000 is too less an amount with a futuristic view. While they strongly proposed to increase it to Rs 5 Lakh per individual and 10 Lakh under special purpose (as specified by RBI), they have given RBI, the power under **Sec 25 (2)(b)** to put ceiling on the amount of microcredit facilities. This particular section also contains that RBI may also put a ceiling on the number of individual clients to whom such microcredit facilities may be provided by any microfinance institution.

iv. **Sec 2(1)(j):** Microfinance Services has been defined as one or more of the following financial services by the MFIs
(A) micro credit facilities
(B) collection of thrift;
(C) pension or insurance services;
(D) remittance of funds to individuals within India

Thrift services has been allowed as Microfinance services and is defined as **"thrift"** means money collected in any form other than in the form of current account or demand deposits, by a micro finance institution from members of self-help groups or any other group of individuals, by whatever name called, who are availing micro finance services provided by such micro finance institution in accordance with the regulations made by the Reserve Bank in this behalf

v. **Sec- 24-**Confers the regulatory powers to the RBI. Some of the key powers conferred upon the regulator is to
- Grant certificate of registration to MFIs (Sec-15)
- Cancellation of license (Sec-16)
- Power to make regulation (limits, margin, APR, prudential norms) (Sec-24(2) and Sec-50)
- Issue directions to MFIs (Sec-25)
- Power to impose penalty (Sec-37)
- Application of Microfinance Development Fund (Sec-50 (2)(l))

vi. **Sec-42- Delegation of Power:** The Central Govt upon consultation with RBI, may delegate any of the powers of RBI to NABARD or any other agency. There is scope for SROs to bid for this role. However, it requires the sectoral commitment to be worth of self regulation.

However the powers to make rules (sec-49), impose penalty (Sec-37) and approval for winding up or closure of the business (Sec-30) cannot be delegated to NABARD or any other entity.

vii. **Sec-33-Grevance Redresal:**

Entrust the function of Grievance redressal to any Ombudsman established under any other scheme framed by the Reserve Bank for clients of banks, with powers to issue directions to micro finance institutions. it has dispensed up with the earlier draft that suggested for Microfinance Ombudsmen schemes. Voluminous complaints may lead to overburdening of the banking/insurance ombudsmen and the quality and early redressal of grievances may get affected.

viii. Sec-10, 11, 12: Provides for establishment of a District Micro Finance Committee in each District, to be headed by the Collector of the District or any officer not below the rank of Additional Collector, to review the growth and development of micro finance activities in the district, monitor over-indebtedness and methods of recovery used by the micro finance institutions and discharge the functions specified in clause 11

ix. Sec-31 and 32: Provided for constitution of the Micro Finance Development Fund tobe applied for the purpose of providing loans, grants or seed capital as also for training of personnel engaged in micro finance institution services. As opposed to the earlier draft wherein the fund was to be housed with RBI, NABARD or any other authority, the present Bill, propose to constitute the fund with the Reserve Bank of India.

x. **Sec-47: Applicability of other Laws:** This section of the Act maintains that the provisions of this Act shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law. But the explanation note to this Section of Act is removed. The earlier explanation stated the following: For removal of doubts it is declared that micro finance services extended by any micro finance institution registered with the Reserve Bank shall not be treated as money-lender for the purpose of any State enactments relating to money-lenders and usurious loans

xi. **Sec-4: Composition of MFDC**: While the total no of members of the committee is retained at 13, the representation of Central Govt has increased to four (4). They are one each from the Ministry or the Department of the Central Government having the administrative control of Finance, Rural Development, Women and Child Development and Housing and Urban Poverty Alleviation, not below the rank of Joint Secretary.

Hence the representation under of Sector Under Sec(4)(g) has come down to only four (4). However, the representatives from Central Government, RBI, NABARD, SIDBI, NHB, have been made ex-officio (total 8)

17.2 FEATURES OF MFI BILL-2012 VIS A VIS THE DRAFT BILL 2011

MFI Bill-2012 As introduced in the Parliament	**Draft MFI Bill 2011**
Preamble: A BILL to provide for development and regulation of the micro finance institutions for the purpose of facilitating access to credit, thrift and other micro finance services to the rural and urban poor and certain disadvantaged sections of the people and promoting financial inclusion through such institutions and for matters connected therewith or incidental thereto.	A BILL to provide access to financial services for the rural and urban poor and certain disadvantaged sections of the people by promoting the growth and development of micro finance institutions as extended arms of the banks and financial institutions and for the regulation of micro finance institutions and for matters connected therewith and incidental thereto.
CHAPTER I: PRELIMINARY	
Sec- 2(1)(a) **"annual percentage rate"** means aggregate rate per annum in percentage consisting of interest, processing fees, service charges and any other charges or fees	“annual percentage rate” means aggregate rate consisting of interest, processing fees, service charges and any other charges or fees charged by the micro finance institution on any financial assistance granted to any client

Sec- 2(1)(b) "client" means any member of the micro finance institution or self-help group or any other group availing the micro finance services from such institution or group	Not Defined
Sec- 2(1)(e) "District Micro Finance Committee" means a Committee constituted by the Reserve Bank under section 10;	Not defined
Sec- 2(1)(f) "margin" means the difference between the annual percentage rate charged by the micro finance institution and the cost of funds raised in percentage by the micro finance institution for providing any micro credit facilities;	"margin" means the difference between the annual percentage rate collected by the micro finance institution for any financial assistance granted to clients and the cost of funds raised and other operational costs incurred by the micro finance institution for grant of and servicing such financial assistance
Sec- 2(1)(g) "Member" means a Member of the Micro Finance Development Council constituted under section 3;	Not defined
Sec- 2(1)(h) "micro credit facilities" means any loan, advance, grant or any guarantee given or any other credit extended in cash or kind with or without security or guarantee	Not defined
Sec- 2(1)(i) "micro finance institution" means,— (A) a society registered under the Societies Registration Act, 1860; or (B) a company registered under section 3 of the Companies Act, 1956; or (C) a trust established under any law for the time being in force; or (D) a body corporate; or (E) any other organisation, as may be specified by the Reserve Bank, the object of which is to provide micro finance services in such manner as may be specified by regulations	"micro finance institution" means an entity (irrespective of its organisational form), which provides micro finance services in the form and manner as may be prescribed
but does not include— (i) a banking company, the State Bank of India including its subsidiary banks, a scheduled bank, a co-operative bank, Export and Import Bank, Reconstruction Bank, National Housing Bank, National Bank, a Regional Rural Bank and Small Industries Development	but does not include- (i) a banking company, State Bank of India, a Subsidiary Bank, a corresponding new bank, a cooperative bank, EXIM Bank, Reconstruction Bank, National Housing Bank, National Bank, a Regional Rural Bank and Small Industries Bank;

Bank; (ii) a co-operative society engaged primarily in agricultural operations or industrial activity or purchase or sale of any goods; (iii) any individual carrying on the activity of money-lending and registered as a moneylender under the provision of any State law which regulates such activities;	ii) a co-operative society engaged primarily in agricultural operations or industrial activity or purchase or sale of any goods; (iii) a cooperative society not accepting deposits from anybody except from its members having voting rights or from those members who will acquire voting rights after a stipulated period of their making deposits as per the law applicable to such cooperative society.
Sec- 2(1)(j) "micro finance services" means any one or more of the following financial services provided by any micro finance institution, namely: (A) micro credit facilities involving such amount, not exceeding in aggregate Five lakh rupees for each individual and for such special purposes, as may be specified by the Reserve Bank from time to time, such higher amount, not exceeding ten lakh rupees, as may be prescribed; (B) collection of thrift; (C) pension or insurance services; (D) remittance of funds to individuals within India subject to prior approval of the Reserve Bank and such other terms and conditions, as may be specified by regulations	"micro finance services" means one or more of the following financial services involving small amounts to individuals or groups: (i) providing micro credit; (ii) collection of thrift; (iii)remittance of funds; (iv)providing pension or insurance services; (v) Any other services as may be specified. in such form and manner as may be prescribed.
Implications: Under Sec25 (2) The Reserve bank has been entrusted with the powers to issue directions ceiling on amount of micro credit facilities and the number of individual clients to whom such micro credit facilities may be provided by any micro finance institution;	----
Removed	"Systemically important micro finance institution" means a micro finance deploying such amount of funds for providing micro credit to such minimum number of clients as may be specified by the Reserve Bank by regulations framed under this Act.

Sec- 2(1)(r) "thrift" means money collected in any form other than in the form of current account or demand deposits, by a micro finance institution from members of self-help groups or any other group of individuals, by whatever name called, who are availing micro finance services provided by such micro finance institution in accordance with the regulations made by the Reserve Bank in this behalf	"thrift" means money collected in any form other than in the form of current account or demand deposits, by a micro finance institution from members of self-help groups or any other group of individuals, by whatever name called, who are availing micro finance services provided by such micro finance institution
Chapter-2 MFDC	
Composition: four officers, one each from the Ministry or the Department of the Central Government having the administrative control of Finance, Rural Development, Women and Child Development and Housing and Urban Poverty Alleviation, not below the rank of Joint Secretary to the Government of India, to be nominated by the Central Government—ex officio Members	two officers, not below the rank of Joint Secretary to the Government of India, one each from the Ministry of Finance and the Ministry of Rural Development – Members
not more than four persons, of whom at least two shall be women, to be nominated by the Central Government, in consultation with the Reserve Bank from amongst persons with experience in the field of banking, rural credit or micro finance or the representatives of micro finance institutions or scheduled banks or any other institution providing micro finance services—Members	not more than six persons, of whom at least two shall be women, to be nominated in consultation with the Reserve Bank from amongst persons with experience in banking, rural credit and micro finance or the representatives of micro finance institutions or scheduled banks or any other institution providing micro finance services - Members
Implication Total member-5 Ex Officio members=8 Sector Representation limited to 4 Central Govt Representation increased to 4	Total members- 13 No Ex officio member Sector Representation limited to 6 Central Govt Representation - 2
Sec- 2(1)(q) State Micro Finance Council In Addition to the functions already mentioned, shall Coordinate the activities of the District Micro Finance Committees in the State; shall submit a quarterly report to the Central Government on the implementation of the measures undertaken for the promotion and development of the micro finance institutions in the State	

Chapter- IV DISTRICT MICRO FINANCE COMMITTEES 10. (1) The Reserve Bank may, constitute a District Micro Finance Committee in each district, to be headed by the Collector or an officer not below the rank of Additional Collector in that district in such manner as may be specified by regulations. (2) The District Micro Finance Committee shall meet at such time and place, as the Collector may direct, at least once in three months and shall observe such rules of procedure in regard to the transaction of business at its meetings, as may be specified by regulations: Provided that the representatives of the Lead Bank of the District, representative of the National Bank in the district, a representative of micro finance institutions operating in the district and beneficiaries of micro finance services shall be invited to the meetings of the District Micro Finance Committees. Explanation.—For the purposes of this section, "Lead Bank" of the District means a bank to which a district is assigned as per the Lead Bank Scheme of the Reserve Bank of India. 11. The District Micro Finance Committee shall discharge the following functions, namely:— (a) to review growth and development of micro finance activities in the district; (b) to monitor over-indebtedness, if any, caused by micro finance institutions in the district; and (c) to monitor whether methods of recovery used by micro finance institutions are in accordance with the guidelines made by the Reserve Bank and to report to the Reserve Bank in respect of the violations, if any. 12. Every District Micro Finance Committee shall submit a quarterly report to the Reserve Bank in such form and manner as may be specified and forward its copy to the State Micro Finance Council.	No mention

CHAPTER V REGISTRATION OF MICRO FINANCE INSTITUTIONS	CHAPTER IV REGISTRATION OF MICRO FINANCE INSTITUTIONS
micro finance institution, in existence at the commencement of this Act, engaged in providing micro finance services before such commencement, Would have apply for registration to the Reserve bank before the expiry of three months. Provided that they may continue to carry on its activity of providing micro finance services till the disposal of such application	Application before expiry of three months No mention of carrying on of the activities
NOF -5 Lakh	NOF-5 lakh
Net owned fund" shall have, mutatis mutandis, the same meaning as assigned to it in the Explanation to sub-section (7) of section 45-IA of the Reserve Bank of India Act, 1934.	
Removed to Sec-28	Sec-13 on Cease and Desist order 13 (1), 13 (2), 13 (3), 13(4)
Completely Removed	Sec-15: Systematically important MFI
CHAPTER VI RESERVE, ACCOUNTS, AUDIT AND RETURNS	
Reserve Fund: Reserves to be created as prescribed Provided that nothing contained in this sub-section shall apply to a NBFCs Registered with RBI which is maintaining such reserve fund pursuant to any provisions of the RBI Act, 1934 or any directions or regulations issued there under	Every MFI registered with RBI under this Act shall create a reserve fund and transfer therein a sum, representing such percentage, as may be specified by the Reserve Bank, of its net profit or surplus realized by providing micro finance services every year as disclosed in the profit and loss account or income and expenditure account and before surplus is utilized for any other purpose: No mention of this
CHAPTER VII FUNCTIONS AND POWERS OF RESERVE BANK	
Sec 25(2)-RBI may issue directions on Ceiling on Amount of microcredit facilities and number of clients	Ceiling on amount of financial assistance and number of individual clients
CHAPTER VIII MICRO FINANCE DEVELOPMENT FUND	
The Central Government may, after due appropriation made by Parliament by law in	The Central Government may, after due appropriation made by Parliament by law in

this behalf, grant such sum of money as that Government may think fit, to the Reserve Bank for being utilized for the purposes specified under sub-section (3) of section 32	this behalf, make to the Reserve Bank, National Bank or any other authority s may be prescribed, grant such sums of money as that Government may think fit for being utilized for the purposes of this Act.
CHAPTER IX REDRESSAL MECHANISM	
Entrust the function of Grievance redressal to any Ombudsman established under any other scheme framed by the Reserve Bank for clients of banks, with powers to issue directions to micro finance institutions	Sec- 31(1)-To appoint as many ombudsmen as it deem fit with framing a scheme under this section
CHAPTER XI DELEGATION OF POWERS	
The Central Government, in consultation with the Reserve Bank may, by notification, delegate any of the powers of the Reserve Bank conferred under this Act, except under sections 30, 37 and 49, to the National Bank or any agency under the control of the Central Government in respect of any micro finance institution or a class of micro finance institutions or micro finance institutions generally, subject to such conditions as it deems fit.	The Reserve Bank may with the Previous approval of the Central Government delegate any of its powers conferred under this Act to the National Bank in respect of any micro finance institution or a class of micro finance institutions generally, by issue of a notification in the Official Gazette
CHAPTER XII MISCELLANEOUS	
Preference in repayment: In the event of any micro finance institution making default in repayment of thrift to its members or clients who had made a contribution to thrift, all the workmen shall be paid their dues in priority to all others and thereafter all such members or clients of such micro finance institution shall have a preference in repayment, and shall have the first charge over the assets of the micro finance institution and specified unencumbered securities, if any, referred to in sub-section (3) of section 18	In the event of a micro finance institution making any default in repayment of thrift to any of its members or eligible clients who had made a contribution to thrift, all members or eligible clients of such micro finance institution shall have a first charge over the specified unencumbered securities referred to in sub-section (3) of section 18
Sec-44: Power to Central Govt to issue Direction to RBI, MFDC, SAC on matters of policy and implementation of Schemes	No mention

The provisions of this Act shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law. Explanation is removed	The provisions of this Act shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law. Explanation : For removal of doubts it is declared that micro finance services extended by any micro finance institution registered with the Reserve Bank shall not be treated as money-lender for the purpose of any State enactments relating to money-lenders and usurious loans

CHAPTER 18: TOP 10 MICROFINANCE INSTITUTIONS IN WORLD

1. BRAC

BRAC,(**Bangladesh Rehabilitation Assistance Committee)** an international development organization based in Bangladesh, is the largest non-governmental development organization in the world, measured by the number of employees and the number of people it has helped, as of November 2012.Established by Sir Fazle Hasan Abed in 1972 soon after the independence of Bangladesh, BRAC is present in all 64 districts of Bangladesh as well as in Afghanistan, Pakistan, Sri Lanka, Uganda, Tanzania, South Sudan, Sierra Leone, Liberia, Haiti and The Philippines as of 2012.

BRAC employs over 100,000 people, roughly 70 percent of whom are women, reaching more than 126 million people. The organization is 70-80% self-funded through a number of commercial enterprises that include a dairy and food project and a chain of retail handicraft stores called Aarong. BRAC maintains offices in 14 countries throughout the world, including BRAC USA and BRAC UK.

What is unique about BRAC is its method of pulling people out of poverty. As one author has said, “BRAC’s idea was simple yet radical: bring together the poorest people in the poorest countries and teach them to read, think for themselves, pool their resources, and start their own businesses” (Barber). This is exactly what BRAC has done and is still doing in Bangladesh and ten other poverty-stricken countries around the world.

BRAC has organized the isolated poor and learned to understand their needs by finding practical ways to increase their access to resources, support their entrepreneurship and empower them to become agents of change. Women and girls have been the focus of BRAC’s anti-poverty approach; BRAC recognizes both their vulnerabilities and thirst for change

Headquarters: Dhaka, Bangladesh
Founded: 1972
Staff size: 44,306
Number of borrowers (2011): more than 5 million
Gross loan portfolio: $646 million

2. GRAMEEN BANK

The Grameen Bank is a Nobel Peace Prize-winning microfinance organization and community development bank founded in Bangladesh. It makes small loans (known as microcredit or "grameencredit"to the impoverished without requiring collateral. The name Grameen is derived from the word *gram* which means "rural" or "village" in the Bengali language.

Micro-credit loans are based on the concept that the poor have skills that are under-utilized, and with incentive, they can earn more money. A group-based credit approach is applied to use peer-pressure within a group to ensure the borrowers follow through and conduct their financial affairs with discipline, ensuring repayment and allowing the borrowers to develop good credit standing. The bank also accepts deposits, provides other services, and runs several development-oriented businesses including fabric, telephone and energy companies. The bank's credit policy to support under-served populations has led to the overwhelming majority (98%) of its borrowers being women.

Grameen Bank originated in 1976, in the work of Professor Muhammad Yunus, Professor at University of Chittagong, who launched a research project to study how to design a credit delivery system to provide banking services to the rural poor. Based on his positive results, in October 1983 the Grameen Bank was authorized by national legislation as an independent bank. In 2006, the bank and its founder, Muhammad Yunus, were jointly awarded the Nobel Peace Prize.In 1998 the Bank's "Low-cost Housing Program" won a World Habitat Award. In 2011, the Bangladesh Government forced Muhammad Yunus to resign from Grameen Bank saying that at age 72, he was years beyond the legal limit for the position.

Headquarters: Dhaka, Bangladesh
Founded: 1983
Staff size: 25,283
Number of borrowers (2011): more than 8.3 million
Gross loan portfolio: $939 million

3. SKS MICROFINANCE

SKS Microfinance Limited (SKS) is a non-banking finance company (NBFC), regulated by the Reserve Bank of India. SKS' mission is to eradicate poverty by providing financial services to the poor. The company operates across 19 of 28 Indian states.

According to a CRISIL Report on Top 50 Indian Microfinance Institutions (MFIs), SKS Microfinance is the largest MFI in India with more borrowers, more branches and more loans as of 30 September 2008. SKS was founded in 1997 by Vikram Akula, who also served as its executive chair until November 2011.

SKS charges an annual effective interest rate between 26.7% and 31.4% for core loan products. At the end of financial year 2010 on 31 March 2011, the company listed a gross loan portfolio of US$925,844,433 with 6,242,266 female active borrowers.

SKS plans "to serve 50 million households across India and other parts of the world and also to create a commercial microfinance model that delivers high value to our customers".[5] The theory is that providing financial services to low-income households helps alleviate poverty.[6]

SKS practices a standardised process of managing loans. They reach distant villages by charging interest rates that clients are willing to pay to avoid starvation, poor money management or government loan sharks.

A 24 February 2012 Associated Press report linked SKS loan collection policies to multiple suicides. Company officials denied the claim, but the Associated Press said internal documents and interviews with more than a dozen current and former employees, independent researchers and videotaped testimony from the families of the dead, showed that top SKS officials had information implicating company employees

Headquarters: Hyderabad, India
Founded: 1998
Staff size: 22,733
Number of borrowers (2011): more than 7.3 million
Gross loan portfolio: $925 million

4. ASA

The **Association for Social Advancement** (ASA) is a non-governmental organization based in Bangladesh which provides microcredit financing. It was established in 1978 by Shafiqual Haque Choudhury and a team of people who were then working for other established NGOs,but who themselves were arguing for a better, more radical way to alleviate the exploitation of rural villages caused by the 1971 Bangladesh atrocities. The founding framework of ASA was aimed at empowering rural landless villagers from the "bottom up" through "people's organizations". These were run by volunteers who advocated that a consciousness for solidarity amongst the village poor would lead to collective social action.[3] ASA has currently over 2.2 million members forming different groups with special emphasis on saving practice and 8,000 employees engaged in disbursing and collecting loans and savings deposits.[4]

For many years, ASA sought to combine social development (in health, education, nutrition, and sanitation) with credit provision, but in 1991, these were abandoned, and ASA shifted its focus solely to microcredit lending.[5] This was because they wanted to stop "donor dependence" and become specialized and financially self-sufficient. Since then, it has become a fully self-sufficient microfinance institution – operating mainly in Bangladesh, but with presence in Africa and South America.ASA offers a wide range of financial services to its clients – including micro-credit, small business credit, regular weekly savings, voluntary savings and life insurance – and follows a simple, standardized, low-cost system of organization, management, savings and credit operations.

Its funding has evolved smoothly: first came generous donors, then some small commercial bank loans, then low-cost loans from a subsidised wholesaler, and finally, as outreach expanded and surpluses piled up, client deposits and retained earnings. But by far the most important of the stable conditions in which ASA has prospered has been the expanding demand from an enormous client pool for the very basic service that ASA offers. The core service has remained the low-value year-long weekly-repayment loan, the staple of its successful growth. ASA has not had to undergo large-scale internal reorganisation or training because the basic product and its delivery have remained largely unchanged Also, savings mobilised from clients are used to provide security against default by protecting the small loan portfolio, instead of being used in more risky ventures like raising capital.

Today, ASA's official mission is to "reduce poverty and improve the quality of life of the poor through the provision of qualitative and responsive micro finance services in an innovative and sustainable way".

ASA offers a successful alternative microfinancing model to that of the Grameen Bank. In December 2007, it placed Number 1 in *Forbes* Magazine's list of the world's top 50 microfinance institutions.Grameen Bank placed Number 16, despite having won the Nobel Peace Prize 2006.

ASA combines low-cost operations and high growth to fuel its success. Its ability to constantly reduce interest rates and focus on efficiency has led to its high profitability. ASA's flat rate was 15% (approximately 32% annual percentage rate) until July 1995, when it dropped to 12.5% at a time when micro-finance institution (MFIs) were coming under increasing criticism in the press for their prices

Headquarters: Dhaka, Bangladesh
Founded: 1978
Staff size: 21,298
Number of borrowers (2011): more than 5 million
Gross loan portfolio: $531 million

5. Compartamos Banco

Compartamos Banco is a Mexican bank and the largest microfinance bank in Latin America, serving more than 2.5 million clients. The bank was founded in 1990 and is headquartered in Mexico City.

The bank is engaged in the credit and insurance sectors. In the Credit division, Compartamos offers a range of loans, including Woman Credit, Additional Credit, Home Improvement Credit, Solidarity Credit and Individual Credit, and in the Insurance division it provides Life Insurance and Integral Insurance. The company has 352 service offices in the Mexican domestic market.

Headquarters: Mexico City, Mexico
Founded: 1990
Staff size: 13,298
Number of borrowers (2011): 2.3 million
Gross loan portfolio: $840 million

6. BASIX

BASIX is a livelihood promotion institution established in 1996 in India. It is headquartered in Hyderabad, Andhra Pradesh. BASIX is a livelihood promotion institution established in 1996, working with over a 3.5 million customers, over 90% being rural poor households and about 10% urban slum dwellers. BASIX works in 17 states - Andhra Pradesh, Karnataka, Orissa, Jharkhand, Maharashtra, Madhya Pradesh, Tamilnadu, Rajasthan, Bihar, Chattisgarh, West Bengal, Delhi, Uttarakhand, Sikkim, Meghalaya, Assam and Gujrat, 223 districts and over 39,251 villages. It has a staff of over 10,000 of which 80 percent are based in small towns and villages.

Headquarters: Hyderabad, India
Founded: 1996
Staff size: 10,000
Number of borrowers (2011): more than 1.5 million
Gross loan portfolio: $281 million

7. Bandhan

The organization works towards poverty reduction and women's empowerment. Prime motive is to touch the lives of the poor. Prducts provided-Loans, Insurance, Funds Transfer Services, Financial Services, Other. Services provided-Full-scale Financial Services, Health, Education, Other

Headquarters: Kolkata, India
Founded: 2001
Staff size: 9,754
Number of borrowers (2011): 3.8 million
Gross loan portfolio: $733 million

8. VIETNAM BANK FOR SOCIAL POLICIES

The Vietnam Bank for Social Policies was established under Premier's Decision No. 131/2002QD-TTg dated October 4th, 2002 and the Government's Decree No. 78/ND-CP dated October 4th, 2002 on providing credit for the poor and other policy beneficiaries; based upon the re-organization of the Bank for the Poor and separation from Vietnam Bank for Agriculture & Rural Development for purpose of detaching policy lending from commercial lending. VBSP is regarded as an efficient tool of the Government in mobilising various resources domestically and internationally to perform the designated socio-policy lending programs of the Government.

Headquarters: Hanoi, Vietnam
Founded: 2003
Staff size: 8,900
Number of borrowers (2011): 8.5 million
Gross loan portfolio: $4.9 billion

9. SPANDANA SPHOORTY FINANCIAL LTD.

Spandana Sphoorty Financial Limited, a microfinance institution (MFI) based in India, is reportedly likely to hire three global firms to manage its initial public offering (IPO): Citigroup, a US-based international financial services conglomerate; Morgan Stanley, a global financial services firm headquartered in New York City; and JM Financial Limited, an integrated financial services group based in India. Spandana reportedly is seeking to raise the equivalent of USD 400 million through the IPO. Bloomberg reports that this information was obtained through "four people with direct knowledge of the matter" [1].

As of 2009 and according to the Microfinance Information Exchange (MIX) Market, the microfinance information clearinghouse, Spandana reports total assets of USD 647 million, a gross loan portfolio of USD 474 million, and 3.6 million borrowers with an average loan balance of USD 129 per borrower. Also as of 2009, Spandana reports a return on assets of 8.99 percent and a return on equity of 55.7 percent.

News of Spandana's possible IPO comes in the wake of another Indian IPO: that of SKS Microfinance, a large Indian microlender. SKS Microfinance's IPO resulted in a company valuation of INR 74.7 billion (USD 1.6 billion)

Headquarters: Hyderabad, India
Founded: 1998
Staff size: 8,328
Number of borrowers (2011): nearly 4.2 million
Gross loan portfolio: $778 million

10. ACLEDA

ACLEDA Bank Plc. is a public limited company, formed under the Banking and Financial Institutions Law of the Kingdom of Cambodia based in Phnom Penh, with 236 offices covering all provinces, as well as 25 in the Lao PDR. ACLEDA started out in 1993 when it began providing micro credits to war victims. By now it is Cambodias major commercial bank. ACLEDA had more than $1,752 million in total assets as of December 31, 2011, and more than $1,323 million in deposits, with over $1,134 million in loans outstanding. According to the National Bank of Cambodia, ACLEDA Bank is the largest domestic commercial bank in terms of total assets and number of clients, with more than 821,900 depositors as of December 31, 2011.

The bank is headed by President & CEO, In Channy, who is one of the original 28 members of the organization. Channy joined the company in 1992 as a loan officer while the bank was still a UN-funded microfinance project. He now serves as Chief Executive Officer of the company, and also serves as Vice-chairman of the International Business Chamber of Cambodia

Headquarters: Phnom Penh, Cambodia
Founded: 1993
Staff size: 7,340
Number of borrowers (2011): 272,300
Gross loan portfolio: $1 billion

CHAPTER 19: FUTURE PROSPECTS OF MICROFINANCE

India will need such a form of lending for the poor is also debateable. While the country enjoys its newfound status as one of the economic engines of the East, the disparity between rich and poor is both vast and shameful.

Bringing the poor into the tax system through employment will enhance the country's growth prospects, but it should be done in a realistic and sustainable way. It should also avoid allowing an industry to develop collection tactics that bear worrying similarities to those of loan sharks

The Reserve Bank of India is preparing a discussion paper on new banks. Meanwhile,

The RBI severely restricts bank licensing. It prohibits industrial houses from opening banks because of a potential conflict of interest: such banks could give unwarranted but preferential credit and write off loans to related companies and other favoured borrowers. This is a valid concern, given India's weak corporate governance.

The RBI wants the next generation of banks to focus on rural lending, to promote financial inclusion. However, rural operations are perilous. All government regional rural banks have suffered heavy losses.

Rural operating costs are high because of poor logistics and scale diseconomies (rural deposit accounts and loans are very small by urban standards). Agricultural defaults in many states are high since political loan waivers have encouraged wilful default. Banks find it politically impossible to seize the land defaulters have pledged. So, despite RBI guidelines and directives to state-owned banks on financial inclusion, they have not penetrated the countryside. By contrast, MFIs have.

Historically, MFIs started as non-profit NGOs. They depended on donations for expansion, and so could not grow fast. To expand their reach, many NGOs converted into for-profit Non-Banking Finance Companies (NBFCs). These NBFCs raised equity from various sources. For every rupee of their own funds, they could borrow six rupees from banks. This enabled them to expand fast.

They raised ever-larger sums for every expansion. Today, major MFIs raise hundreds of crores at a time. Till now, private equity players have been willing to provide the money.

RBI guidelines say new banks must have equity capital of at least Rs 300 crore, and no promoter group should have a stake of over 10%.

Other MFIs may launch public issues within a year. This causes much heartburn among NGOs, who fear the social ethos of MFIs is losing out to commercial orientation. Maybe, but the traditional NGO approach created only small boutiques of rural credit, whereas rural India needs giant networks. Giant networks require massive capital, which can be attracted only by for-profit corporations. Besides, scale economies will permit giant MFIs to lower their interest rates to poor clients.

The RBI has said that NBFCs— can apply for bank licences. But these urban giants lack the rural skills and reach of MFIs

However, MFIs may not want to become banks. MFIs are free of RBI regulation, and have flourished in the consequent freedom to innovate and expand. The RBI takes ages to approve bank branches, while MFIs open several every month. MFIs have cheap, flexible staff, but as banks they will face high, unionized wages and inflexibilities. As banks, they will have to put 25% of their money into government securities and 6% with the RBI, suffering losses on this count. Political loan waivers could devastate the loan discipline that keeps their repayments today at 98-99%. Some MFIs want to do non-financial things like selling consumer goods cheaply to borrowers, which will be difficult for a regular bank.

However, a bank status will let MFIs accept deposits, hugely reducing their cost of funds. Instead of borrowing from banks at 12-14%, they can gather deposits at 3-6%. This will also help their clients, who want savings avenues. A half-way solution — and an excellent first step — will be to allow major MFIs to accept deposits. This will help lower their lending rates while providing savings outlets to poor villagers.

In the 1990s, several NBFCs went bust and could not repay depositors, so the RBI now bans all NBFCs from accepting deposits. Non-profit MFIs can accept deposits, but not for-profit MFIs, which are formally NBFCs.

This rule must be changed. Major MFIs have an excellent track record in both social and financial terms, and should not be treated like run-of-the mill NBFCs. Rather, major MFIs with equity capital of over Rs 300 crore (the benchmark for new banks) should be allowed to accept deposits. This will immediately improve financial inclusion. And some deposit-taking MFIs may evolve into full banks. That’s the way to go.

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CHAPTER 20: PROFFESIONAL OPOURUNITIES IN MICROFINANCE

1. Preparation of Risk mitigation policy.
2. Preparation of resolution strategy.
3. Statutory/Regulatory compliance.
4. Corporate advisory services.
5. Investment advisory services to investors.
6. Independent director on board.

7. Internal audit.
8. Statutory Audit under the Companies Act 2013.
9. Legal due diligence.
10. Drafting & vetting of legal documents
11. Accounting of Microfinance.
12. Registration with Regulatory Authorities
13. Advisory on Compliance Accounting Standards.
14. Maintenance of corporate and trust accounts
15. Foreign Contribution Compliance with Foreign Exchange Management Act 1999

CHAPTER 21: ANNEXURE

ANNEXURE 1

Self Regulatory Organization (SRO) for NBFC-MFI

Annex 1

Self – Regulatory Organization for NBFC-MFIs – Criteria for Recognition

i. The SRO should have at least 1/3rd of the NBFC-MFIs registered as its members, at the time of recognition.

ii. It should have adequate capital to be able to discharge its functions without being overly dependent on subscription from members.

iii. The memorandum / bye laws of the Self-Regulatory Organization (SRO) should specify criteria for admission of members and the functions it will discharge, as one of its main objects;

iv. The Memorandum / bye laws of an SRO should provide for the manner in which the Governing Body / Board of Directors of the SRO would function.

v. The Board should have adequate representation from both large and small NBFC-MFIs.

vi. 1/3rd of the Board of Directors should be independent and not associated with member institutions.

vii. The Board of Directors and individuals comprising the management should be considered fit and proper, by the Reserve Bank.

viii. It should have adequate internal controls in place.

ix. The SRO should function in the interest of all the stake holders and not seen to be only an industry body.

x. The SRO should frame a Code of Conduct to be followed by its members.

xi. It should have a Grievance Redressal Mechanism and a Dispute Resolution Mechanism in place, including a specially appointed Grievance Redressal Nodal Officer.

xii. It should be in a position to exercise surveillance over its members to ensure compliance with the Code of Conduct and regulatory prescriptions of the Bank through an Enforcement Committee

xiii. It should also have a developmental function of training and awareness programmes for its members, for the Self Help Groups and conduct research and development for the growth of the MFI sector

Annex 2

Obligations of the SRO towards the Reserve Bank

i. The SRO, once recognized, will need to nominate a Compliance officer who will directly report to the Reserve Bank and who will keep the Reserve Bank regularly posted of all developments in the sector.

ii. The SRO will have to submit its Annual Report to the Reserve Bank.

iii. It will have to conduct investigation into areas of concern as pointed out by the Reserve Bank.

iv. The SRO shall inform the Reserve Bank of the violations of the provisions of the Act, the directions, the circulars or the guidelines issued by the Reserve Bank from time to time, by any of its members.

v. It shall provide information, including data, to the Reserve Bank periodically or as requested for by the Bank.

vi. The Reserve Bank shall, if need arises, inspect the books of the SRO or arrange to have the books inspected by an audit firm.

ANNEXURE 2

Master Circular – Corporate Governance

I Guidelines on Corporate Governance

1.Constitution of Audit Committee

2.Constitution of Nomination Committee

3.Constitution of Risk Management Committee

4.Disclosure and transparency

5.Connected Lending

II Rotation of partners of the statutory auditors audit firm - with public deposits/deposits of Rs 50 crore and above

I. Guidelines on Corporate Governance

As it is evident, the need for good corporate governance has been gaining increased emphasis over the years. Globally, companies are adopting best corporate practices to increase the investors confidence as also that of other stakeholders. Corporate Governance is the key to protecting the interests of the stake-holders in the corporate sector. Its universal applicability has no exception to the Non-Banking Financial Companies (NBFCs) which too are essentially corporate entities. Listed NBFCs which are required to adhere to listing agreement and rules framed by SEBI on Corporate Governance are already required to comply with SEBI prescriptions on Corporate Governance. In order to enable NBFCs to adopt best practices and greater transparency in their operations following guidelines are proposed for consideration of the Board of Directors of all Deposit taking NBFCs with deposit size of Rs 20 crore and above and all nondeposit taking NBFCs with asset size of Rs 100 crore and above (NBFC-ND-SI).

1. Constitution of Audit Committee

In terms of extant instructions, an NBFC having assets of Rs. 50 crore and above as per its last audited balance sheet is already required to constitute an Audit Committee, consisting of not less than three members of its Board of Directors, the instructions shall remain valid.

In addition, NBFC-D with deposit size of Rs 20 crore may also consider constituting an Audit Committee on similar lines.

2. Constitution of Nomination Committee

The importance of appointment of directors with 'fit and proper' credentials is well recognised in the financial sector. In terms of Section 45-IA (4) (c) of the RBI Act, 1934, while considering the application for grant of Certificate of Registration to undertake the business of non-banking financial institution it is necessary to ensure that the general character of the management or the proposed management of the non-banking financial company shall not be prejudicial to the interest of its present and future depositors. In view of the interest evinced by various entities in this segment, it would be desirable that NBFC-D with deposit size of Rs 20 crore and above and NBFC-ND-SI may form a Nomination Committee to ensure 'fit and proper' status of proposed/existing Directors.

3.Constitution of Risk Management Committee

The market risk for NBFCs with Public Deposit of Rs.20 crore and above or having an asset size of Rs.100 crore or above as on the date of last audited balance sheet is addressed by the Asset Liability Management Committee (ALCO) constituted to monitor the asset liability gap and strategize action to mitigate the risk associated. To manage the integrated risk, a risk management committee may be formed, in addition to the ALCO in case of the above category of NBFCs.

4.Disclosure and transparency

The following information should be put up by the NBFC to the Board of Directors at regular intervals as may be prescribed by the Board in this regard:

- progress made in putting in place a progressive risk management system, and risk management policy and strategy followed

- conformity with corporate governance standards viz. in composition of various committees, their role and functions, periodicity of the meetings and compliance with coverage and review functions, etc.

5.Connected Lending

The Bank has received suggestions in the matter with reference to paragraph 2(vi) of the circular dated May 28, 2007 containing instructions on connected lending. The suggestions are being studied and the instructions contained in paragraph 2 (vi) of the said circular will become operational after final evaluation of the suggestions and modifications, if any considered necessary.
NBFCs shall frame their internal guidelines on corporate governance, enhancing the scope of the guidelines without sacrificing the spirit underlying the above guidelines and it shall be published on the company's web-site, if any, for the information of various stakeholders.

II. Rotation of partners of the statutory auditors audit firm - with public deposits/deposits of Rs 50 crore and above

4. The need for good corporate governance has been gaining increased emphasis over the years. Globally, Companies are adopting best corporate practices to increase the investors confidence as also that of other stakeholders. Scrutiny of the books of account conducted by auditors rotated periodically would add further value in strengthening corporate governance.

5. In this context, it would be desirable if NBFCs with public deposits / deposits of Rs 50 crore and above, stipulate rotation of partners of audit firms appointed for auditing the company. The partner/s of the Chartered Accountant firm conducting the audit could be rotated every three years so that same partner does not conduct audit of the company continuously for more than a period of three years. However, the partner so rotated will be eligible for conducting the audit of the NBFC after an interval of three years, if the NBFC, so decides. Companies may incorporate appropriate terms in the letter of appointment of the firm of auditors and ensure its compliance.

ANNEXURE 3

Guidelines on Fair Practices Code for NBFCs

A. (i) Applications for loans and their processing

(a) All communications to the borrower shall be in the vernacular language or a language as understood by the borrower.

(b) Loan application forms should include necessary information which affects the interest of the borrower, so that a meaningful comparison with the terms and conditions offered by other NBFCs can be made and informed decision can be taken by the borrower. The loan application form may indicate the documents required to be submitted with the application form.

(c) The NBFCs should devise a system of giving acknowledgement for receipt of all loan applications. Preferably, the time frame within which loan applications will be disposed of should also be indicated in the acknowledgement.

(ii) Loan appraisal and terms/conditions

The NBFCs should convey in writing to the borrower in the vernacular language as understood by the borrower by means of sanction letter or otherwise, the amount of loan sanctioned along with the terms and conditions including annualised rate of interest and method of application thereof and keep the acceptance of these terms anD conditions by the borrower on its record. As complaints received against NBFCs generally pertain to charging of high interest / penal interest, NBFCs shall mention the penal interest charged for late repayment in bold in the loan agreement. It is understood that in a few cases, borrowers at the time of sanction of loans are not fully aware of the terms and conditions of the loans including rate of interest, either because the NBFC does not provide details of the same or the borrower has no time to look into detailed agreement. Not furnishing a copy of the loan agreement or enclosures quoted in the loan agreement is an unfair practice and this could lead to disputes between the NBFC and the borrower with regard to the terms and conditions on which the loan is granted.

NBFCs are, therefore, advised to furnish a copy of the loan agreement preferably in the vernacular language as understood by the borrower along with a copy each of all enclosures quoted in the loan agreement to all the borrowers at the time of sanction / disbursement of loans.

(iii) Disbursement of loans including changes in terms and conditions

(a) The NBFCs should give notice to the borrower in the vernacular language as understood by the borrower of any change in the terms and conditions including disbursement schedule, interest rates, service charges, prepayment charges etc. NBFCs should also ensure that changes in interest rates and charges are effected only prospectively. A suitable condition in this regard should be incorporated in the loan agreement.

(b) Decision to recall / accelerate payment or performance under the agreement should be in consonance with the loan agreement.

(c) NBFCs should release all securities on repayment of all dues or on realisation of the outstanding amount of loan subject to any legitimate right or lien for any other claim NBFCs may have against borrower. If such right of set off is to be exercised, the borrower shall be given notice about the same with full particulars about the remaining claims and the conditions under which NBFCs are entitled to retain the securities till the relevant claim is settled/paid.

(iv) General

(a) NBFCs should refrain from interference in the affairs of the borrower except for the purposes provided in the terms and conditions of the loan agreement (unless new information, not earlier disclosed by the borrower, has come to the notice of the lender).

(b) In case of receipt of request from the borrower for transfer of borrowal account, the consent or otherwise i.e. objection of the NBFC, if any, should be conveyed within 21 days from the date of receipt of request. Such transfer shall be as per transparent contractual terms in consonance with law

(c) In the matter of recovery of loans, the NBFCs should not resort to undue harassment viz. persistently bothering the borrowers at odd hours, use of muscle power for recovery of loans etc. As complaints from customers also include rude behavior from the staff of the companies. NBFCs shall ensure that the staff are adequately trained to deal with the customers in an appropriate manner.

(v) The Board of Directors of NBFCs should also lay down the appropriate grievance redressal mechanism within the organization to resolve disputes arising in this regard. Such a mechanism should ensure that all disputes arising out of the decisions of lending institutions' functionaries are heard and disposed of at least at the next higher level. The Board of Directors should also provide for periodical review of the compliance of the Fair Practices Code and the functioning of the grievances redressal mechanism at various levels of management. A consolidated report of such reviews may be submitted to the Board at regular intervals, as may be prescribed by it.

(vi) Fair Practices Code (which should preferably in the vernacular language as understood by the borrower) based on the guidelines outlined hereinabove should be put in place by all NBFCs with the approval of their Boards within one month from the date of issue of this circular. NBFCs will have the freedom of drafting the Fair Practices Code, enhancing the scope of the guidelines but in no way sacrificing the spirit underlying the above guidelines. The same should be put up on their web-site, if any, for the information of various stakeholders.

(vii) Complaints about excessive interest charged by NBFCs (issued vide CC No. 95 dated May 24, 2007)

The Reserve Bank has been receiving several complaints regarding levying of excessive interest and charges on certain loans and advances by NBFCs. Though interest rates are not regulated by the Bank, rates of interest beyond a certain level may be seen to be excessive and can neither be sustainable nor be conforming to normal financial practice. Boards of NBFCs are, therefore, advised to lay out appropriate internal principles and procedures in determining interest rates and processing and other charges. In this regard the guidelines indicated in the Fair Practices Code about transparency in respect of terms and conditions of the loans are to be kept in view.

**(viii) Regulation of excessive interest charged by NBFCs (Notification No. DNBS. 204 /
CGM (ASR)-2009 dated January 2, 2009)**

(a) The Board of each NBFC shall adopt an interest rate model taking into account relevant factors such as, cost of funds, margin and risk premium, etc and determine the rate of interest to be charged for loans and advances. The rate of interest and the approach for gradations of risk and rationale for charging different rate of interest to different categories of borrowers shall be disclosed to the borrower or customer in the application form and communicated explicitly in the sanction letter.

(b) The rates of interest and the approach for gradation of risks shall also be made available on the web-site of the companies or published in the relevant newspapers. The information published in the website or otherwise published should be updated whenever there is a change in the rates of interest.

(c) The rate of interest should be annualised rates so that the borrower is aware of the exact rates that would be charged to the account.

(ix) Clarification regarding repossession of vehicles financed by NBFCs (issued vide CC No. 139 dated April 24, 2009)

NBFCs must have a built in re-possession clause in the contract/loan agreement with the borrower which must be legally enforceable. To ensure transparency, the terms and conditions of the contract/loan agreement should also contain provisions regarding: (a) notice period before taking possession; (b) circumstances under which the notice period can be waived; (c) the procedure for taking possession of the security; (d) a provision regarding final chance to be given to the borrower for repayment of loan before the sale / auction of the property; (e) the procedure for giving repossession to the borrower and (f) the procedure for sale / auction of the property. A copy of such terms and conditions must be made available to the borrowers in terms of circular wherein it was stated that NBFCs may invariably furnish a copy of the loan agreement along with a copy each of all enclosures quoted in the loan agreement to all the borrowers at the time of sanction / disbursement of loans, which may form a key component of such contracts/loan agreements.

B. NBFC-MFIs:

In addition to the general principles as above, NBFC-MFIs shall adopt the following fair practices that are specific to their lending business and regulatory framework.

i. General:

a. The FPC in vernacular language shall be displayed by an NBFC-MFI in its office and branch premises,

b. A statement shall be made in vernacular language and displayed by NBFC-MFIs in their premises and in loan cards articulating their commitment to transparency and fair lending practices,

c. Field staff shall be trained to make necessary enquiries with regard to existing debt of the borrowers,

d. Training if any, offered to the borrowers shall be free of cost. Field staff shall be trained to offer such training and also make the borrowers fully aware of the procedure and systems related to loan / other products,

e. The effective rate of interest charged and the grievance redressal system set up by the NBFC-MFI should be prominently displayed in all its offices and in the literature issued by it (in vernacular language) and on its website,

f. A declaration that the MFI will be accountable for preventing inappropriate staff behavior and timely grievance redressal shall be made in the loan agreement and also in the FPC displayed in its office/branch premises,

g. The KYC Guidelines of RBI shall be complied with. Due diligence shall be carried out to ensure the repayment capacity of the borrowers,

h. As specified in the NBFC-MFIs (Reserve Bank) Directions, 2011, all sanctioning and disbursement of loans should be done only at a central location and more than one individual should be involved in this function. In addition, there should be close supervision of the disbursement function,

i. Adequate steps may be taken to ensure that the procedure for application of loan is not cumbersome and loan disbursements are done as per pre-determined time structure.

ii. Disclosures in loan agreement / loan card

a. All NBFC-MFIs shall have a Board approved, standard form of loan agreement. The loan agreement shall preferably be in vernacular language.

b. In the loan agreement the following shall be disclosed.

i. All the terms and conditions of the loan,
ii. that the pricing of the loan involves only three components viz; the interest charge, the processing charge and the insurance premium (which includes the administrative charges in respect thereof),
iii. that there will be no penalty charged on delayed payment,
iv. that no Security Deposit / Margin is being collected from the borrower,
v. that the borrower cannot be a member of more than one SHG / JLG,
vi. the moratorium between the grant of the loan and the due date of the repayment of the first instalment (as guided by the NBFC-MFIs(Reserve Bank) Directions, 2011),
vii. an assurance that the privacy of borrower data will be respected.
c. The loan card should reflect the following details as specified in the Non – Banking Financial Company - Micro Finance Institutions (Reserve Bank) Directions, 2011.

(i) the effective rate of interest charged

(ii) all other terms and conditions attached to the loan

(iii) information which adequately identifies the borrower and

(iv) acknowledgements by the NBFC-MFI of all repayments including installments received and the final discharge.

(v) The loan card should prominently mention the grievance redressal system set up by the MFI and also the name and contact number of the nodal officer
(vi) Non-credit products issued shall be with full consent of the borrowers and fee structure shall be communicated in the loan card itself.
(vii) All entries in the Loan Card should be in the vernacular language.

iii. Non-Coercive Methods of Recovery

As specified in the NBFC-MFIs (Reserve Bank) Directions, 2011, recovery should normally be made only at a central designated place. Field staff shall be allowed to make recovery at the place of residence or work of the borrower only if borrower fails to appear at central designated place on 2 or more successive occasions. NBFC-MFIs shall ensure that a Board approved policy is in place with regard to Code of Conduct by field staff and systems for their recruitment, training and supervision. The Code should lay down minimum qualifications necessary for the field staff and shall have necessary training tools identified for them to deal with the customers. Training to field staff shall include programs to inculcate appropriate behavior towards borrowers without adopting any abusive or coercive debt collection / recovery practices. Compensation methods for staff should have more emphasis on areas of service and borrower satisfaction than merely the number of loans mobilized and the rate of recovery. Penalties may also be imposed on cases of non-compliance of field staff with the Code of conduct. Generally only employees and not out sourced recovery agents be used for recovery in sensitive areas.

iv. Internal control system:

As the primary responsibility for compliance with the Directions rest with the NBFC MFIs, they shall make necessary organizational arrangements to assign responsibility for compliance to designated individuals within the company and establish systems of internal control including audit and periodic inspection to ensure the same.

C. Lending against collateral of gold jewellery:

While lending to individuals against gold jewellery, NBFCs shall adopt the following in addition to the general guidelines as above.

i. They shall put in place Board approved policy for lending against gold that should inter alia, cover the following:

a. Adequate steps to ensure that the KYC guidelines stipulated by RBI are complied with and to ensure that adequate due diligence is carried out on the customer before extending any loan,

b. Proper assaying procedure for the jewellery received,

c. Internal systems to satisfy ownership of the gold jewellery,

d. The policy shall also cover putting in place adequate systems for storing the jewellery in safe custody, reviewing the systems on an on-going basis, training the concerned staff and periodic inspection by internal auditors to ensure that the procedures are strictly adhered to. As a policy, loans against the collateral of gold should not be extended by branches that do not have appropriate facility for storage of the jewellery,

e. The jewellery accepted as collateral should be appropriately insured,

f. The Board approved policy with regard to auction of jewellery in case of non repayment shall be transparent and adequate prior notice to the borrower should be given before the auction date. It should also lay down the auction procedure that would be followed. There should be no conflict of interest and the auction process must ensure that there is arm's length relationship in all transactions during the auction including with group companies and related entities,

g. The auction should be announced to the public by issue of advertisements in at least 2 newspapers, one in vernacular language and another in national daily newspaper.

h. As a policy the NBFCs themselves shall not participate in the auctions held,

i. Gold pledged will be auctioned only through auctioneers approved by the Board.

j. The policy shall also cover systems and procedures to be put in place for dealing with fraud including separation of duties of mobilization, execution and approval.

ii. The loan agreement shall also disclose details regarding auction