

Legislative Brief

The Micro Financial Sector (Development and Regulation) Bill, 2007

The Bill was introduced in the Lok Sabha on March 20, 2007.

It has been referred to the Standing Committee on Finance (Chairperson: Shri Ananth Kumar) on April 27, 2007. The Committee is scheduled to submit its report within three months.

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Highlights of the Bill

- ◆ The Micro Financial Sector (Development and Regulation) Bill, 2007 seeks to promote the sector and regulate micro financial organisations (MFO).
- ◆ National Bank for Agriculture and Rural Development (NABARD) shall regulate the micro financial sector.
- ◆ Every MFO that accepts deposits needs to be registered with NABARD. Conditions for registration include (a) net owned funds of at least Rs 5 lakh; and (b) at least three years in existence as an MFO. All MFOs, whether registered or not, shall submit annual financial statements to NABARD.
- ◆ Every MFO that accepts deposits has to create a reserve fund by transferring a minimum of 15% of its net profit realised out of its thrift and micro finance services every year.
- ◆ The central government may establish a Micro Finance Development Council to advise NABARD on formulation of policies related to the micro financial sector.
- ◆ NABARD shall constitute a Micro Finance Development and Equity Fund to be utilised for the development of the sector.

Key Issues and Analysis

- ◆ While the Bill promotes the activities of MFOs, there are differing opinions on the cost efficiency of the MFO model.
- ◆ NABARD is designated as the regulator of the micro financial sector. However, its dual role as a key participant in the sector and the regulator could lead to conflict of interest.
- ◆ Banks and deposit taking Non-Banking Financial Companies (NBFCs) have to comply with Reserve Bank of India's (RBI) prudential norms designed to safeguard depositors' funds. While the Bill enables NABARD to prescribe norms for MFOs, it specifies some norms which are less stringent than for banks and NBFCs.
- ◆ Unlike banks regulated by RBI, the Bill does not exempt registered MFOs from the Usurious Loans Act, 1918 or state laws which cap interest rates.
- ◆ The Bill defines "micro financial services" to include insurance and pension services without specifying to whom such services are to be provided. This implies that every insurance and pension company would be regulated by NABARD.

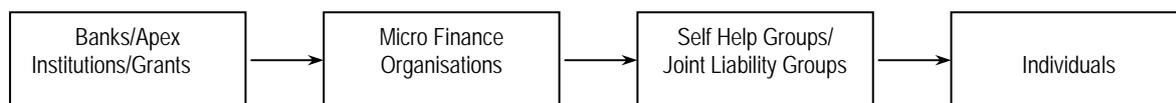
PART A: HIGHLIGHTS OF THE BILL¹

Context

Micro finance is defined as the provision of thrift (savings), credit and other financial services and products of very small amounts to the poor for enabling them to raise their income levels and improve living standards.² In India, micro finance is provided by apex development financial institutions (such as National Bank for Agriculture and Rural Development - NABARD, Small Industries Development Bank of India, and Rashtriya Mahila Kosh), commercial banks, regional rural banks, co-operative banks, non banking financial companies (NBFCs)* and various not-for-profit entities.³

There are different mechanisms through which the delivery of micro credit loans takes place. Banks may lend directly to customers. Second, NABARD sponsors the Self Help Group-Bank Lending Programme (SBLP).⁴ Under SBLP, self help groups (SHGs) need to save regularly for a minimum of six months and maintain prescribed records and accounts in order to become eligible to be linked to local banks. This programme provides credit to 22.38 lakh SHGs.⁵ Third, commercial banks or apex institutions lend to micro finance organizations (MFOs) for further lending to groups or individuals (see Chart 1).

Chart 1: Institutional Flow of Micro Finance



MFOs lend to SHGs and joint liability groups (JLGs, which are also known as grameen groups).⁴ The number of MFOs in India involved in lending activities is estimated to be around 800.³ These MFOs vary significantly in size, outreach and credit delivery methodologies. Presently, the lending activities of MFOs are not regulated except for those registered as NBFCs.³

Table 1: Difference between SHGs and Grameen/JLGs

	SHGs	Grameen/JLGs
Size	Upto 20 members	5-15 members
Nature of Loan	Single loan to the SHG as a whole, which decides how it should be allocated.	Loan recorded in the names of Individual borrowers.

Source: Microfinance in India: A State of the Sector Report, 2006, Prabhu Ghate, CARE, Swiss Agency for Development and Cooperation, and Ford Foundation

A number of committees have deliberated the manner in which MFOs should be regulated and supervised.⁶ The Micro Financial Sector (Development and Regulation) Bill, 2007 seeks to promote the micro finance sector and provide a regulatory framework for MFOs.

Key Features

Micro Finance Organisations

- The Bill defines an MFO as any organisation that provides micro finance services and includes societies, trusts, and co-operative societies (except co-operative banks, agricultural co-operative societies, and co-operative societies engaged in industrial activity or sale of any goods and services). The definition of MFO excludes SHGs and groups of SHGs.
- An MFO may provide micro financial services to an “eligible client”. Such services may be in the form of financial assistance which cannot exceed (a) Rs 50,000 in aggregate per individual for small and tiny enterprise, agriculture, and allied activities or (b) Rs 1.5 lakh in aggregate per individual for housing purposes. These services also include insurance and pension services, and such other services as may be specified by NABARD.
- An “eligible client” is defined as any member of an SHG or any group formed to provide micro finance services to certain categories of people. The categories include (a) any farmer owning a maximum of two hectares of agricultural land; (b) agricultural cultivators such as oral lessees and share croppers; (c) landless and migrant labourers; (d) artisans and micro entrepreneurs; and (e) women.

* The Reserve Bank of India defines NBFC as a non-banking institution which is a loan company or an investment company or an asset finance company or a mutual benefit financial company.

Promotion and Regulation of MFOs

- NABARD shall promote and ensure the orderly growth of the micro financial sector. It may (a) formulate policies for transparency and good governance; (b) set sector related benchmarks on methods of operation; (c) facilitate the development of credit rating norms; and (d) specify accounting and auditing norms for MFOs.
- Every MFO that offers thrift services to eligible clients needs to obtain a certificate of registration from NABARD. Thrift service is defined as acceptance of savings of eligible clients i.e., acceptance of deposits from clients). All MFOs (including those not offering thrift services) need to file their returns with NABARD at intervals to be prescribed.
- A registration certificate may be granted by NABARD if certain conditions are met such as (a) the general character of the management is not prejudicial to the interest of eligible clients; (b) the net owned funds[†] of the MFO is at least Rs 5 lakhs; (c) the MFO has been in existence for at least three years. Any existing MFO offering thrift services needs to apply for registration within six months of the enactment of the legislation. However, no applicant will be rejected without an opportunity of being heard.
- NABARD may cancel the registration if an MFO ceases to provide thrift services or fails to comply with any of the conditions on which the registration was granted or any direction issued by NABARD or does not submit account books or other documents for inspection. An MFO may be granted time to comply with NABARD's directions if it is not against public interest or the micro financial sector or eligible clients. If an MFO violates any prescribed provision, NABARD may also prohibit such MFO from accepting thrift. However, the MFO would be given the opportunity of being heard.
- NABARD may authorise an inspecting authority to inspect any MFO and submit a report. If NABARD considers that an MFO's operation is harming eligible clients, it may take appropriate action including winding up of the MFO. The MFO shall be allowed to make a representation with regard to the report.
- Every MFO has to create a reserve fund by transferring a minimum of 15% of its net profit or surplus realised out of thrift services and micro finance services. NABARD may direct that this fund be invested in specified securities. In case the MFO defaults in repayment of deposits, its depositors shall have first charge over such securities.
- NABARD may frame a scheme for appointment of one or more Micro Finance Ombudsman for settlement of disputes between eligible clients and micro finance organisations.
- The central government may establish a Micro Finance Development Council to advise NABARD on formulation of policies related to the orderly growth and development of the micro finance sector.
- An MFO may appeal to the central government or any authority prescribed by the central government if it is aggrieved by the decision of rejection or cancellation of registration or any order prohibiting the acceptance of thrift or for winding up of the MFO. The appeal has to be made within a period of 60 days from the date on which the order was passed.

Micro Finance Development and Equity Fund

- NABARD shall constitute a Micro Finance Development and Equity Fund to be utilised for the development of the micro finance sector. The Fund would include (a) all grants received from the government and other sources; (b) any income received from investments made in equity of an MFO; and (c) the balance outstanding in the Fund maintained by NABARD before the commencement of the Act.
- The Fund would be managed by the Board of Directors of NABARD and would be used to provide any financial assistance to an MFO, invest in equity of an MFO, and meet any other expenses for the promotion of the micro finance sector.

Offences and Penalties

- If any person wilfully makes a false statement or omits to make a material statement in any application or returns, he is liable to be imprisoned for a maximum term of two years and a fine. If any other prescribed provisions are contravened, the person shall be liable to a fine of maximum Rs 20,000. He shall be further liable to a fine of Rs 1,000 for each day's contravention after the first or shall be imprisoned for a maximum period of two years or with both.
- If any person does not comply with the order to stop thrift services or the orders of the Ombudsman or the central government, he shall be punishable with imprisonment for a maximum of three years and shall be liable to a fine of a minimum of Rs 500 for each day during which such non-compliance continues.
- A court would take cognizance of an offence under the legislation only on a complaint made by an officer of NABARD. No court below the Metropolitan Magistrate or a Judicial Magistrate of the First Class shall try any offence under the proposed legislation.

[†] Net owned funds means the net worth or shareholder's funds.

PART B: KEY ISSUES AND ANALYSIS

Purpose of the Bill

The Bill has two broad objectives: (a) to promote and regulate the micro finance sector; and (b) to permit MFOs to collect deposits from eligible clients.

The major issues that arise out of these objectives are as follows: (i) whether MFOs are the appropriate vehicle to address credit needs of the poor; (ii) whether NABARD is the appropriate body to regulate the sector; and (iii) whether there are adequate safeguards to protect depositors' funds.

Efficiency of MFOs

Commercial banks have fixed costs per transaction. Therefore, the transaction costs as a percentage of the loan amount rises as the loan size decreases. This deters banks from lending small amounts. Typically, lending to small borrowers follows an indirect route. Banks lend to MFOs who then lend to various SHGs and JLGs. Individual borrowers get funds through SHGs and JLGs.

Proponents of this model claim that (a) it is characterised by low transaction costs and high repayment rates²; (b) it provides access to credit to the under-served⁴; and (c) the work of SHGs also builds livelihood capacity and social capital among the poor.⁷ However, there is an opposing view which suggests that MFOs do not incur lower transaction costs but transfer the cost to donors through subsidised borrowings or to borrowers through higher interest rates. For example, NABARD funds commercial banks at 7.5 per cent per annum, banks on-lend to MFOs at 10-15 per cent, MFOs then lend to SHGs at 12-24 per cent and the groups lend to individual members at 24-36 per cent.⁸

There is also evidence that repayment rates slacken as the size of the loan increases and as the frequency of borrowing rises. For example, in the Grameen Bank, the default rate was 0.4 per cent among first-time borrowers, 1.2 per cent among second-time borrowers, 6.6 per cent among third-time borrowers and 9.5 per cent among fourth-time borrowers.⁸

Table 2: Comparative Cost Structure of Bank, NBFC and MFO

	Bank	NBFC	MFO
Average Interest rate on lending (%)	8.3	10.6	19.1
Average Interest rate on borrowing (%)	5.3	6.3	6.6
Net Interest Spread (%)	3.0	4.3	12.5
Operation Cost as % of loans	3.9	2.5	9.6

Note: Data used for banks is State Bank of India, 2006-07; for NBFCs, Sundaram Finance Ltd., 2005-06; and for MFOs, Bangladesh Grameen Bank, 2005. Averages calculated by PRS.

Role of NABARD as Regulator

The Bill has designated NABARD as the regulator for the micro financial sector. However, NABARD also provides equity capital and debt funds to MFOs. This raises the issue of conflict of interest between its various roles. Other deposit taking entities (banks and NBFCs) are regulated by RBI. The conflict between RBI's various roles has also been a matter of discussion. The recent High Powered Expert Committee Report on Making Mumbai an International Financial Centre (Chairperson: Percy Mistry)⁹ published in March 2007 addresses some of the issues.

Prudential Norms

Presently, the Reserve Bank of India (RBI) regulates the collection of public deposits. Organisations authorised to do so are subject to the prudential norms set by RBI, with a view to the safety of the savings/deposit. Other than banks, NBFCs are allowed to accept public deposits if they follow the regulations prescribed by RBI. Table 3 outlines the prudential norms for deposit taking NBFCs and commercial banks. In addition, all deposits with banks are insured upto Rs 1 lakh, ie if a bank is unable to honour its liabilities, deposits upto Rs 1 lakh would be paid by the Deposit Insurance and Credit Guarantee Corporation of India.

The Bill allows MFOs to offer thrift services if they meet certain prescribed provisions. The Bill has prescribed conditions that have to be met before an MFO can offer thrift services. They include: (a) the net owned funds of an MFO has to be at least Rs 5 lakh, and (b) the MFO has to be in existence for three years before it can offer thrift services. The minimum net owned funds required is not related to the amount of deposits taken by the MFO. However, NABARD may prescribe other norms for an MFO.

Table 3: Key Prudential Norms for NBFCs taking Public Deposits and Banks

	NBFCs taking Public Deposits	Banks
Net Owned Funds	Rs 2 crore	Rs 300 crore
Capital Adequacy Ratio	Minimum of 12%	Minimum of 9%
Non Performing Assets	Need to make provisions against non performing assets	Need to make provisions against non performing assets
Credit Rating	Minimum investment grade or other specified credit rating	None
Period of Public Deposit	Between 1 year and 5 years	Current and demand deposits and minimum 7 days for time deposits
Interest Rate on Deposits	Interest rate ceiling specified (now 12.5% per annum)	No restrictions
Transfer to Reserve Fund	20% of profits	None
Investment in Approved Securities	Minimum 10% of liquid asset in approved securities and 5% in unencumbered term deposits with any scheduled commercial bank	Minimum 25% of liabilities in approved securities
Limit of Deposits	4 times net owned funds for lease companies and 1.5 times net owned fund for loan and investment companies	None

Source: Reserve Bank of India

There are two points of view on allowing MFOs to offer thrift services. The first point of view argues that such a provision would increase the outreach of micro financial services. It would also offer an alternative to the poor, who had to rely on riskier and lower yielding savings instruments.¹⁰ The other point of view argues that if prudential norms for such MFOs are lowered it might put depositors' money at risk. Since MFOs offering thrift services mainly cater to the poor, allowing a lower level of protection for their savings might lead to further impoverishment, especially of women who form the majority of SHGs in the country.¹¹

An Advisory Committee appointed by the RBI recommended that in view of the need to protect the interests of depositors, MFOs may continue to extend micro-credit services to their clients but should not be permitted to accept public deposits unless they comply with the extant regulatory framework of the RBI. The Committee further added that MFOs could play an important role in facilitating access of their clients to savings services from the regulated banks.¹²

Since NBFCs and Section 25 companies shall also be regulated by the Bill, it is not clear whether they would follow the prudential norms set by RBI or NABARD.

Formation of Reserve Fund

MFOs are required to transfer 15% of the net profit to a reserve fund as a protection to depositors. However, if an MFO offering thrift services does not make any profit and thereby does not form the reserve fund, there is no safety net for the depositors.

Definitions

The Bill has not defined "Self Help Group" and "Joint Liability Group", though it refers to these terms.

Any organisation providing "micro financial services" is defined as a "micro financial organisation." All micro financial organisations are regulated by NABARD. "Micro financial services" includes life insurance, general insurance and pension services approved by their respective regulating authorities. However, the definition does not specify to whom such services are to be provided. This implies that every insurance or pension company serving any individual would be regulated by NABARD.

Exemption from Usurious Loans Act, 1918

The Bill does not exempt registered MFOs offering thrift services from the Usurious Loans Act, 1918 or state laws which prohibit charging of excessive interest rates (such as Tamil Nadu Money Lenders' Act, 1957, Kerala Money Lenders' Act, 1958). This could lead to dual regulation of MFOs offering thrift services. The rate of interest charged by banks is exempted from the Usurious Loans Act, 1918 and any other law related to indebtedness in force in any state.¹³

Notes

1. This Brief has been developed on the basis of The Micro Financial Sector (Development and Regulation) Bill, 2007 introduced in Lok Sabha on March 20, 2007. It has been referred to the Standing Committee on Finance (Chairperson: Shri Ananth Kumar) on April 27, 2007. The Committee is scheduled to submit its report within three months.
2. Summary and Recommendations of the Task Force on Supportive Policy and Regulatory Framework for Microfinance, NABARD, 1999.
3. "Extracts from an article presented at the APRACA Seminar at Manila on Regulation of MFIs in July 2004 by K.Muralidhara Rao, General Manager, NABARD," National Bank for Agriculture and Rural Development (see http://www.nabard.org/microfinance/mf_institution.asp).
4. "Microfinance in India: A State of the Sector Report, 2006," Prabhu Ghate, CARE, Swiss Agency for Development and Cooperation, and Ford Foundation.
5. "Annual Report: 2006-07," Ministry of Finance, Government of India.
6. For example, Working Group (constituted by Government of India) on Legal & Regulation of MFIs, 2002; Informal Groups (appointed by RBI) on Micro Finance which studied issues relating to (i) Structure & Sustainability, ii) Funding (iii) Regulations and (iv) Capacity Building, 2003; Advisory Committee (appointed by RBI) on flow of credit to agriculture and related activities from the Banking System, 2004.
7. "Microfinance and Poverty Alleviation," Kamal Vatta, Economic and Political Weekly, February 1, 2003.
8. "The Microcredit Alternative?" Madhura Swaminathan, Economic and Political Weekly, March 31, 2007.
9. The report is available at <http://finmin.nic.in/mifc.html>
10. "Consumer Protection in Indian Microfinance: Lessons from Andhra Pradesh and the Microfinance Bill," Prabhu Ghate, Economic and Political Weekly, March 31, 2007.
11. "One Step Forward or Two Step Back? Proposed Amendments to NABARD Act," Smita Premachander and M. Chidambaranatham, Economic and Political Weekly, March 24, 2007.
12. "Report of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System," Submitted to Reserve Bank of India, Mumbai, June 2004.
13. Section 21A of The Banking Regulation Act, 1949.

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