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Regulating Microfinance Institutions in India

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Regulating Microfinance Institutions in India

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<u>Abstract</u>

Providing an enabling regulatory and supervisory framework is necessary for facilitating the expansion of financial services, preventing distortions of competition, and protecting customer's interests. Microfinance institutions (MFIs) are heterogeneous in their nature and operations, and their clients are often from the vulnerable segments of the population. We analyse the MF Bill 2012 and propose various changes so as to aid the growth of this sector. The pricing of credit needs to be revisited to provide flexibility to MFIs in their operations. Moreover, stipulations such as 75% income generation in case of qualifying assets, income criteria for borrowers, and geographical diversification should be decided by the market players alone. The regulations should be enforced based on the size of the MFI and not the structure; for instance, NBFC-MFIs should be allowed to securitise and list their securities. Lastly, the policy on local area banks should be revisited to examine whether these institutions can be used for financial inclusion.

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Executive Summary

Extending access to financial services to the poor is possible through several means. Microfinance (MF) is just one such tool. Providing an enabling regulatory and supervisory framework is necessary for facilitating the expansion of the financial services, to prevent distortions of competition, and to protect customer's interest. It has been widely accepted that MF has features that are different from conventional banking. Additionally, MF institutions are heterogeneous in their nature and operations, and their clients are often from the vulnerable segment of the population.

In this research project, we first track the literature to understand the regulatory framework followed in various countries that has aided both financial inclusion as well as the securities market integration. Many countries are still in the learning stages, using their Central Bank as their regulator. However, we find Bangladesh and Bolivia are far ahead with an MF regulation in place. They are probably good examples to emulate, even though they are relatively small countries.

The objective of the study is to understand and provide suggestions based on our inter actions with the market participants, our analysis of the proposals in the present MF Bill 2012 in terms of regulation, and our review of the status of regulation in aiding the growth of novel products like micro-pensions, micro-insurance, and securitization of loans. Additionally, we took into consideration the view of experts on (a) the changing regulatory framework in India related to access to financial services, (b) how regulations of MFIs can be modified to enhance financial inclusion without sacrificing regulatory oversight, and(c) how regulatory changes will enable the seamless integration of MFIs and the securities market. We feel that the redressal mechanism should be entrusted to the National Bank for Agriculture and Rural Development (NABARD).NABARD can handle redressals, with the RBI Offices of the Banking Ombudsman (OBO)functioning as the Appellate Authority.

The pricing of credit needs to be revisited to provide flexibility to MFIs in their operations. Moreover, stipulations such as 75% income generation in case of qualifying assets, income criteria for borrowers, geographical diversification, and so on should be decided by the market players.

Our analysis shows that the securitization guidelines need to be modified to enable NBFC-MFIs to securitize and list their securities. The regulations should be limited to large NBFC-MFIs as they are systemically important MFIs (Tier I MFIs). The regulation should be enforced based on the size of the MFI and not the structure. Lastly, the policy on local area banks should be revisited to examine whether these institutions can be used for financial inclusion.

Regulating Microfinance Institutions in India

1. Introduction

Extending access to financial services to the poor is possible through several means. Microfinance (MF) is just one such tool. Providing an enabling regulatory and supervisory framework is necessary for facilitating the expansion of the financial services, to prevent distortions of competition, and to protect customer's interest. It has been widely accepted that MF has features that are different from conventional banking. Additionally, MF institutions (MFIs) are heterogeneous in their nature and operations, and their clients are often from the vulnerable segment of the population. There is a growing need to regulate MF activities as well as MF institutions.

The proposed MF Bill 2012 that is waiting to be passed in Parliament would give immense powers to the Reserve Bank of India (RBI) in terms of regulation. All along, this sector was not regulated. As the current regulation affects investment in microfinance through foreign funding restrictions, our exploration of how restrictions on debt financing and external commercial borrowing (ECB) and limitations on equity investment have hindered foreign funds from reaching MFIs is of direct relevance to national and international investors. Our discussion of a more sophisticated financial product regulation relating to products such as securitization—undertaken to see how this regulation can be improved to encourage investment in the sector—will be of interest to a number of stakeholders in the financial sector. Although securitization of MFI loans holds promise of providing sustainable long-term resources, the same has been stymied by stringent regulations, knowledge limitations and logistics. The MFIs also need to have long-term vision necessary to adopt additional strategies to enhance their clients' social welfare through non-financial initiatives.

In addition to its relevance to MFIs and investors, this research is relevant to policymakers seeking to create a more enabling financial infrastructure. With the current policy priority of maximizing financial inclusion, this informed research will be an important input to evidencebased policy making, particularly when it comes to making decisions on unorthodox capital financing innovations that have the power to reach low-income households.

The rest of this research paper is organized as follows. Section 2 lays out the objectives of the study, while Section 3reviews the relevant literature on regulation from other countries and compares them to regulation in India. Section 4 defines the topic of research. Section 5discusses the framework and the development of the questionnaire, and Section 6 discusses the results of this questionnaire with experts. Section7concludes the paper with a few suggestions.

2 Objectives of the Study

1. What is the status of the current regulatory framework in various countries with reference to MF?
2. What are the current proposals in the present MF Bill 2012 in terms of regulation? How useful are they in aiding the growth of access to financial services in India?
3. What is the status of regulation in aiding the growth of novel products such as micro-pensions, micro-insurance, and securitization of loans?
4. How do experts view the changing regulatory framework in India with regard to access to financial services?
5. How can the scope of the regulations governing MFIs be modified to enhance financial inclusion without sacrificing regulatory oversight?
6. What regulatory changes would enable a seamless integration of MFIs and the securities market?

3. Literature Review

Whether regulation aids or stifles the growth of any sector is a matter of debate across the world; microfinance is no exception. In the light of the same, it would be worthwhile to analyze the regulation related to microfinance in various parts of the world where MF has spread in different forms. We start with a few countries in Latin America, move on to Africa, and come closer home to the Asia-Pacific region to Bangladesh and finally India.

3.1 Latin America

In Latin America, micro finance is being provided by commercially oriented and sophisticated microfinance institutions which have proved to be a great success. Most MFIs in Latin America prefer to be commercial players. Their track record of financial performance is impressive. The MFIs are regulated by the financial authorities in their countries and have been co-opted into the formal financial system as banks or microfinance institutions-specialised institutions.

Microfinance providers in Latin America can be broadly characterized in three categories:

- Non-governmental organizations(NGOs) that have transformed into regulated institutions (upscaling)
- Banks that have entered into the microfinance market (downscaling)
- Traditional proximity financial institutions created to serve the micro-entrepreneur market

a) Bolivia

In the mid-nineties, four NGOs voluntarily choose to be regulated and adopted the norms established in the Banking Law of 1993. The Financial System Supervisory Authority (FSSA) (earlier The Superintendence of Banks and Financial Institutions) formulated MFIs norms in 1995. An important provision was that financial NGOs were to be converted into public corporations if they wanted to become regulated MFIs. They were known as Private Financial Funds (PFFs). However, many financial NGOs preferred to be unregulated non-profit entities called Development Finance Institutions(DFI). These institutions seemed to prefer their purpose- to provide microfinance services to the financially excluded probably due to the poverty and informal nature of activity.

Currently, the FSSA has proposed regulation for the DFIs. They can, however, retain their legal status as non-profit enterprises. These norms will enable strengthening the institutions. Hence, financial institutions whether regulated or otherwise need to adhere to changes in financial prescriptions.

b) Peru

MFIs in Peru have been rapidly growing in the last decade. They have created a niche area in the un-served market by banking institutions. However, the banking institutions too have started to compete in this area have seen the success for the MFIs. In Peru, MFIs have to adhere to the same norms as banking and other financial institutions, with some differences in the minimum capital requirement and number of operations allowed. The regulation and supervision of these institutions have to take into account the changing landscape and impact of New Basel Capital Accord on MFIs.

The regulations proposed include entry norms, regulations of credit risk, market risk, liquidity risk and market exit(moving from non-profit to corporate model) are some of the proposed regulations.

3.2 Africa

a) Tanzania

A decade ago in Tanzania the financial sector reforms were introduced. The reform measures include no mandated credit allocation, liberalized interest rate regime, restructuring of state-owned financial institutions etc. Entry of private sector banks was seen in August 2012. Further Bank of Tanzania role in regulating and supervising financial institutions was strengthened. Tanzania had 20 licensed banks and 11 non-bank financial institutions which was quite shallow. A few banks have a countrywide network and most of the banks were operating out of Dares Salaam. Three commercial banks have entered the microfinance sector.

The principal providers of microfinance services are Savings and Credit Cooperatives (SACCOs) and several foreign, donor-assisted NGOs. They preceded the establishment of a microfinance-specific regulatory framework, operating in several key areas where there is limited access to external funds and lack of skilled manpower with banking and financial competence. The regulatory frameworks for microfinance institutions (MFIs) and cooperative financial institutions (CFIs) are still in the process of being enacted into pertinent laws and corresponding implementing regulations.

Savings and Credit Cooperatives (SACCOs), several donor-assisted NGOs were providing the bulk of micro-finance services. The regulatory frameworks and related laws and implementation for microfinance institutions (MFIs) and cooperative financial institutions (CFIs) are in the evolving stage

b) Kenya

Kenya was affected by droughts and high inflation rates in 2008 and 2009. However, the micro finance sector seemed to be unaffected. The progressive and innovative approaches adopted by the Central Bank and Government emphasized financial access for developing the economy. The operation expenses remain relatively low perhaps due to the large deposit base and well-developed MFIs. Hence most of these institutions were highly profitable.

Kenyan microfinance has shown resilience despite local droughts and the high inflation rates that afflicted the nation in 2008 and 2009. With the Kenyan government and the Central Bank of Kenya emphasizing financial access as a key to modernizing the economy, the sector has been strengthened by progressive policies and innovative approaches to delivering financial services. A large deposit base, along with the existence of well-developed MFIs, allowed financial and operational expenses to remain relatively low and led to some of the highest profitability measures in the Sub-Saharan Africa(SSA) region

The success of M-Pesa in mobile banking, passing of the Finance Act of 2010 allowing for agent banking, development of credit bureaus etc were reflective of the progressive and innovative government policy. Though the loan portfolio and total deposits showed an increasing trend since 2008, it seemed there was a strong savings culture and hence the MFI outreach to the savers was more predominant. Customer needs were met by MFIs with the high level of products offered. However, the growth was primarily due to clientele in the urban areas.

3.3 Asia-Pacific

The Asian microfinance market structure varies significantly across countries, depending on the stage of financial development, the level of economic development, the policy environment, and so on. Institutions providing microfinance in Asia play a critical role in increasing the access to finance for underprivileged people, especially those in rural areas.

a) Bangladesh

The success of the Grameen Bank model propounded that the poor were bankable and collateral was not required is well known. In 1983 the bank was established and in August 2012

Bangladesh got the identity of being the “birth place of microcredit”. The success story attracted a number of NGOs into the sector.

The Central Bank, Bangladesh Bank, 4-state owned commercial banks, 5 government-owned specialized development banks, 30 domestic private commercial banks, 9 foreign-owned commercial banks, 29 non-bank financial institutions(NBFIs) and the Grameen Bank (specialized microfinance bank) cover the landscape of the formal financial sector. The largest market share belongs to the private commercial banks (assets & liabilities). The Microcredit Regulatory Authority (MRA) has approved the functioning of more than 500 microfinance institutions. In addition, the financial system consists of insurance companies, stock exchanges and cooperative banks. There are four main types of institutions in the microfinance sector in Bangladesh. These are the Grameen Bank, NGOs (over a thousand, of which around 500 are licensed MFIs), commercial and specialized banks and government sponsored microfinance programmes.

The Microcredit Regulatory Authority (MRA) has been established in August 2006 consequent to the enactment of the Microcredit Regulatory Authority Act, 2006. The Act was based on the draft submitted by the National Steering Committee Accordingly, the Microcredit Regulatory Authority (MRA) is the regulatory and supervisory body of microfinance institutions in Bangladesh which issues licenses which is mandatory for operating microfinance activities in Bangladesh. However, Grameen Bank as a bank remains out of the supervisory purview of the MRA.

The MRA Act which is the basis of regulatory requirements has a scope to expand further by forming rules. The drafted a set of rules to implement the law is waiting at final stage for approval from the government. The formal shape of the institutional set up would be enabled by these rules. The rules include issue of service charge, thrift collection, good governance, rights and responsibilities of clients, reserve requirement, liquidity requirement, financial transparency, audit, savings collection, sources of funds etc among others. This draft rules has been finalized after thorough consultation with the sector at different levels.

b) Pakistan

In Pakistan there are microfinance banks (MFBs), microfinance NGOs, commercial banks in addition to the government sponsored Rural Support Programmes (RSPs). The State Bank of Pakistan (SBP) regulates the MFBs and commercial banks. Microfinance NGOs and RSPs, neither of which can accept deposits, are registered by either the Securities and Exchange Commission of Pakistan or provincial authorities. There is a specialized law for MFBs -. the Microfinance Institutions Ordinance as well as prudential regulations for MFBs. The SBP has also issued specific guidelines on Islamic microfinance. Through a public-private partnership among the SBP, the microfinance industry and a private sector credit bureau a pilot Microfinance Credit Information Bureau was launched in May 2010 in Lahore .

To govern the microfinance activities of the MFBs State Bank of Pakistan has a separate legal framework under which the Microfinance Banks (MFBs) are licensed and regulated. Based on the feedback of the key stakeholders improvements have been made taking into account the evolving needs of the sector. SBP encourages creation of new MFBs and conversion of sustainable MFIs into MFBs so as to mainstream microfinance into overall financial system.

c) India

A study of the history of MF in India shows that many NGO microfinance institutions (MFIs) were funded by donor support in the form of revolving funds and operating grants. In recent years, development finance institutions such as the National Bank for Agriculture and Rural Development(NABARD) and the Small Industries Development Bank of India(SIDBI) have provided bulk loans to MFIs. This has resulted in MFIs becoming intermediaries between the largely public-sector development financial institutions and retail borrowers consisting of groups of poor people or individual borrowers living in rural areas or urban slums. In another model, NABARD refinances commercial bank loans to self-help groups (SHGs) in order to facilitate relationships between the banks and poor borrowers. This movement has witnessed significant progress over the last 10 years and has brought about changes to the rural banking system.

Since microfinance was taken up mainly as a development initiative rather than as a commercial activity, the voluntary development agencies (or NGOs) who were registered as societies, trusts, or Section 25 companies did not think of looking at alternative institutional forms for providing these services, although some cooperatives and one cooperative bank were also engaged in microfinance specifically. As the scale of operations of microfinance activities started growing and the desirability of undertaking such activity on a for-profit basis started coming into focus, the larger institutions started to feel the need for a transformation in their legal structure. As a result, MFIs in India can now be found in the form of non-banking financial companies (NBFCs) as well. Many MFIs in India operate as cooperatives under the conventional state-level cooperative acts, the national-level multi-state cooperative legislation, or under the new state-level Mutually Aided Cooperative Societies Act (MACS Act). A more recent trend is to register MFIs as companies. Some are registered as not-for-profit companies under Section 25 of the Companies Act, at least partially to take advantage of the RBI's exemption from registration for such companies providing microfinance services. Another form of registration that indicates a bolder, overtly commercial (and in the long term, institutionally more sustainable) approach to microfinance is the establishment of a for-profit company followed by registration with the RBI as an NBFC. A number of MFIs are considering this route, and a few either have already transformed into NBFCs or are in the process of doing so.

Until very recently, the Government of India (GoI) regulations did not allow external commercial borrowing (ECB) for financial sector institutions. In the Finance Bill for 2005–2006, the microfinance sector was allowed access to ECB. As per the notification issued by the RBI in 2005, NGOs engaged in microfinance activities are allowed to access foreign borrowing. Further modifications were made to these regulations by the RBI in 2012.

Owing to their structure and the charitable nature of their objectives, societies and trusts are not an option for the capital market. Though there is nothing in the legislation that prohibits them from accessing capital markets, the lack of an ownership structure is a major impediment for capital markets to take an interest in financing such institutions (para 3.6,Sa-Dhan Report, 2006.)

Cooperative societies and cooperative banks(with their distinctly for-profit constitution)can obtain funds from capital markets, theoretically. However, the dismal fiduciary performance of urban co-operative banks (UCBs) in recent years is a major dampener on any attempt such institutions may make to access these markets. NBFCs can also access capital markets, provided they adhere to the prudential and reporting norms of the RBI. Both types of institutions need to report their capital market transactions periodically to the central bank in the prescribed format. In order to access equity funds from capital markets, NBFCs need to be listed with a stock exchange. They would need to offer an issue. Issues can be classified as public, rights, or preferential (also known as private placements).The Securities and Exchange Board of India (SEBI), which regulates the functioning of capital markets, has laid down eligibility norms for entities accessing the primary market through public issues. Currently, the stock markets in India are the National Stock Exchange of India (NSE) and the Bombay Stock Exchange (BSE).

An MFI could explore the capital markets in two ways: to raise capital for the microfinance institutions by getting listed or by raising debt instruments; and to offer market-related products (such as money market mutual funds) to its clients. These kinds of products are currently not offered by MFIs much, but they could be beneficial to both the clients as well as the MFIs due to the lower transaction costs associated with products like these that have higher volumes.

4. Defining Regulation and Microfinance

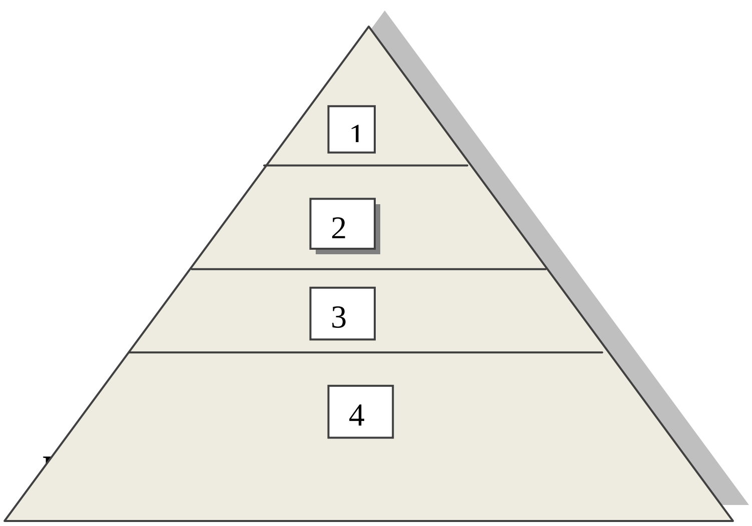
According to Christen et al. (2003, p. 3),"prudential regulation is aimed specifically at protecting the financial system as a whole as well as protecting the safety of small deposits in individual institutions." Prudential regulations set out guidelines for financial intermediation or using repayable funds (e.g., deposits) to make loans. They entail reserve requirements and other measures to ensure the stability and liquidity of the institution. Non-prudential regulation touches on a broad spectrum of issues, including consumer protection, fraud prevention, establishing credit information services, secured transactions, interest rate limits, foreign ownership limitations, and tax and accounting issues.

Hence, regulation may be defined as "A principle, rule, or law designed to control or govern conduct."Financial regulation could be defined as laws and rules that are promulgated by government regulators, stipulating what financial institutions such as banks, brokers, and investment companies (and MFIs) can do, and are aimed at protecting investors, maintaining orderly markets, and promoting financial stability by setting minimum standards for capital and conduct and ensuring compliance by making regular inspections and investigating and prosecuting misconduct. Regulations could be prudential (e.g., capital requirements, non-performing asset norms, investment norms, and so on) and non-prudential (e.g., consumer protection, fraud prevention, and so on). Prudential as well as non-prudential regulations ensure orderly development of the institutions and markets.

Microcredit, micro-savings, and micro-insurance are the major products offered by microfinance institutions. Pension and remittances are also offered but are not used a lot. The term **microfinance** embraces all these efforts as well as the collection of savings from low-income households, the provision of insurance, and in some cases such as the Bangladesh Rural Advancement Committee (now known as the BRAC) in Bangladesh, the assistance in distributing and marketing clients' output (Armendariz and Murdoch, 2011).

5. Framework for Analysis

A microfinance institution in India can lend without registration at present, though the proposed MFI Bill suggests mandatory registration a prerequisite for lending. Each legal structure has different requirements and privileges. The framework proposed in Meehan (2004) was used as a guide to map and classify MFIs in India so as to understand whether this regulation would impact classification. Figure 1 illustrates the segmentation of the sector into four tiers as discussed in Balasubramanian et al. (forthcoming).



Tier 1: Mature and best-known MFIs with strong financial and operational track record. Most are regulated.At most, 2% of all MFIs; the Top 50 or 100.

Tier 2: Successful but smaller, younger, or simply less well-known MFIs.At or near profitability. Mostly NGOs; consider conversion. Majority will progress up. 8% of all MFIs.

Tier 3: MFIs approaching profitability. Understandable shortcomings due to young organization, lack of capital, weak MIS, or other needs. Nearly all NGOs. Some will progress up. 20% of all MFIs.

Tier 4: Mix of unprofitable MFIs: start-ups, post-conflict settings, weak institutions, or those for which microfinance is not the focus. Some will progress up. 70% of all MFIs.

We visited and interviewed MFIs in Tamil Nadu with varying asset size, number of clients, and type of legal status. The MFIs were registered as NBFCs, NBFC-MFIs, Section 25 Companies, Trusts, or Societies. The MFIs were asked about various aspects of regulations, their choice of current regulator, reporting mechanism to regulator, onsite inspection if any by institution, and so on (the original questionnaire is reproduced in Appendix 1). Further, they were quizzed on the frequency of reporting as well as regulatory and non-regulatory hurdles (if any) that they faced. Finally, we inquired if they securitized their loans and sold them to banks as part of the priority sector target of the banks.

6. Analysis of Results

The analysis starts with a discussion of the history of the proposed MFI Bill waiting for the Parliamentary nod for implementation, and looks at some very important provisions before discussing the responses from our primary survey of MFIs. This will bring in clarity and context to this section.

The Indian microfinance sector whose institutions were subject to little regulation a few years ago witnessed tremendous growth over the last few years. Suddenly, the MFIs found themselves in a quagmire, with the regulators at the central and state level bringing about new norms—prudential and non-prudential—which seemed to stymie their future growth. It is generally believed that the new norms were a fallout of the Andhra Pradesh Micro Finance (MF) crisis. To quote from the Report of the Committee on Financial Sector Reforms: "The regulated respond to the needs and opportunities in the marketplace while attempting to comply only with the letter of the law. The regulator then attempts to stamp out violations of the spirit through new rules…".One wonders if this is a case of the regulator realizing the enormous growth of the MF industry a little late, or whether they were unaware of the issues in the MF industry.

Initially, the MF sector in India was led by the bank-SHG model. The objective of the model was to encourage thrift among the group members and to lend within the group. However, over a period of time the MFIs became more commercially oriented and started adopting company structures. Banks supported the growth of these MFIs as they found an able ally to meet their mandated priority sector norms. The corporate formed under section 25 of the Companies Act, 1956 were exempt from the rigors of RBI regulations or registration and reporting. Hence, the section companies were used by the promoters for pilot runs and testing of new waters.

The attractive returns on investments of these institutions lured the private equity (PE) players; in their quest for impressive returns, they found a perfect match in MFIs who were looking to scale up operations. According to the RBI's Annual Report 2011–2012, "an uneasy relationship existed between the for-profit MFIs registered as NBFCs and the state governments in the southern part of the country where the MFIs were concentrated on issues relating to multiple lending, over-indebtedness of the borrower, higher rate of interest charged, and coercive recovery practices. This concern was amplified by the perception that the MFI sector was disproportionately benefitting the private shareholders, including PE funds and other foreign investors, at the expense of poor borrowers. Consequently, the Andhra Pradesh (A.P.) government promulgated the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Act in October 2010 to regulate the functioning of microfinance entities in the state. The provisions of the Act were onerous to comply with and resulted in bringing all MFI activities (including lending and collection activities) by NBFCs to a complete halt.

In response, the RBI appointed the Malegam Committee to study the issues and concerns in the sector. Based on the recommendations in the Malegam Committee Report, the RBI issued Regulatory Guidelines for MFIs in December 2011. The Guidelines address issues such as eligibility parameters for classification as NBFC-MFI in the form of qualifying assets, entry point norms for NBFC-MFIs, prudential norms (including capital adequacy and provisioning norms), pricing of credit, transparency in interest rates, multiple lending, over-borrowing, ghost-borrowing, fair practices in lending, coercive methods of recovery, corporate governance, and so on.

However, the sector (in particular AP-based NBFCs) plunged into a severe crisis; the entire AP-based portfolios of the NBFCs had to be either provided for or written off, adversely affecting their net owned funds (NOF) and capital adequacy."* The RBI has been considerate in bringing about changes in the regulations by "phasing out compliance to entry point capital by March 2014; redefining qualifying assets as those created on or after January 01, 2012; removal of 26 per cent cap on interest rate to allow for operational flexibilities and putting in place margin caps of 10 per cent for large NBFC-MFI (with asset size of Rs.1 billion and above) and 12 per cent for others. In addition, the provisioning made towards AP portfolio as on March 2013 would be added back notionally over a period of five years till March 2017 for the purpose of ensuring compliance to NOF and CRAR".** A revised Fair Practices Code was also put in place taking into account the specific business model of the MFIs.

However, whether the regulations have been adequate or whether it needs further tweaking to ensure orderly development of the MFIs needs to be explored. It is heartening to note that the Government of India is in favor of NBFCs, as mentioned in the Alok Nigam Report:"NBFCs have a significant economic role, especially servicing the under-banked and unbanked populace and geographies". The RBI has also been in favor of the segment, and introduced a new category of NBFCs on December 2, 2011, namely, the Non-banking financial company-Microfinance institutions (NBFC-MFIs).

On August 3, 2012, the RBI slightly modified some aspects of this circular. Though these are welcome changes, two important issues that require revisiting and clarification are a) the quantum of finance aspect in the MFI Bill, which is from the MF institution's perspective, and b) the thrift collection aspect, which is from the client's perspective. These two aspects are discussed below.

a) Quantum of finance

"A micro finance institution (MFI) is defined as an organization, other than a bank, providing micro finance services (which could be a society, company, trust, body corporate or any other organization as may be specified by RBI). These services are defined as micro credit facilities not exceeding Rs.5 lakh in aggregate, or with the Reserve Bank's (RBI) specification Rs.10 lakh, to each individual."*.

The MFI Bill has raised the loan credit limit tenfold, a move that could alter the character of these lenders from tiny loan providers to the poor to financers of the relatively affluent. In its

*RBI Annual Report 2011-12 page 115 Box VI.4
** DNBS(PD) CC.No.250/03/.10.01/2011-12 dated December 2, 2011& DNBS (PD) CC.No.300 /03.10.038/2012-13 dated August 03 , 2012
* PRS Legislative Research, Bill Summary, The Micro Finance Institution (Development and Regulation) Bill, 2012

circular dated December 02, 2011, the RBI introduced a new category of NBFC-MFIs and defined a qualifying asset of a NBFC-MFI to mean a loan that satisfies a number of criteria and restricted the loan amount to INR 35,000 in the first cycle and INR 50,000 in subsequent cycles. It is not clear whether there could be two sets of MFIs—NBFC-MFIs that can give loans only upto INR 35,000/INR 50,000, and another category of MFIs consisting of non-NBFC-MFIs that can grant loans up to INR 5 lakh.

b) Thrift collection

Clause 2(r) provides for thrift to be collected by the entities covered by the MFI Bill. However, it does not throw enough light as to whether NBFC-MFIs can collect thrift. Moreover, the Bill is silent on deposit insurance. While deposits with banks that are highly regulated entities are covered by the Deposit Insurance and Credit Guarantee Corporation(DICGC), the poor are not given any such protection when they deposit their savings with the entities mentioned in the Bill. It is ironic that the vulnerable section of the society is not afforded insurance cover for their deposits, while the non-vulnerable section (the better-off segment) of society is given insurance cover simply because they can afford to bank with mainstream institutions.

We now analyze the results of our questionnaire, which evolved from the review of the extant literature and discussions with experts; the questionnaire was piloted before we started full-fledged data collection. The unit of analysis was the MFI. One of the main reasons for this was to understand from the perspective of the MF institutions how the various ways regulation would affect them as well as their clients. Further, we wanted to understand whether regulation would affect an MFI depending on the classification of the institution and the reasons why the MFIs chose to be registered under a specific classification. With the list of MFIs available from NABARD, we could only do convenience sampling as several MFIs were either unavailable or their contact details were not reachable.

As our analysis involves only simple averages we feel that the present sample of 49 institutions is representative of the population (Appendix 2) gives the list on MFIs in Tamil Nadu that were studied as part of this research project).The key questions in the questionnaire are analyzed in the following sections. The analysis consists of two sections: the first section deals with regulations that can primarily affect MF institutions and the second section deals with regulations that could affect the clients of MFIs. In both the sections, an attempt has been made to compare the results from discussion with the MF institutions with the present state of regulation as well as expert opinions.

6.1 Regulation from MF institutions' perspective

6.1.1 Legal structure of NBFCs

The number of clients of NBFCs was very high compared to those of other categories of MFIs; the number varied between 1 lakh and 20 lakh. The other categories of MFIs had a maximum of about 20,000 clients (Table 1).This could be attributed to various factors; two factors, however, stand out:

- The number of years an organization was in the MF business
- The MFI's ability to raise capital and hence lend it to its clients

Table 1: Legal Structure of MF Institution vs. No. of Clients

Tier	%of Institutions	No. of Clients
Tier 2	26.53	1–20 Lakh
Tier 3	14.28	7000–20000
Tier 4	59.18	2000–45000

Most MFIs seemed to agree that a 'broad-brush' approach to regulation was not required; smaller MFIs and the institutions that were new and registered as a Section 25 company or a trust and/or a society may have lighter regulations initially, and can be brought under tighter norms as they grow and became more important systemically. At the same time, most MFIs emphasized that regulations are critical and welcomed them. They preferred to be regulated as this would bring about clarity, which would help them do business in an environment that is more secure in terms of their actions, as it involves others' money.

*According to the Basel Committee on Banking Supervision (BCBS),–"non-banks that mobilise deposits from the public should be subject to regulation and supervision commensurate to the type and size of their transactions. In general, microfinance oversight, whether over banks or other deposit taking institutions, should weigh the risks posed by this line of business against supervisory costs and the role of microfinance in fostering financial inclusion."The same analogy could be extended to non-deposit-accepting MFIs, more so since they do not accept deposits from the public; they could be subject to regulation and supervision commensurate with the size of their transactions rather than form.

According to Principle 19 (Supervisory approach) and Principle 20 (Supervisory techniques),"Given the characteristics of microfinance and microfinance institutions, some techniques used to supervise conventional retail banking activities are not appropriate. Cost and feasibility considerations may allow for alternative supervisory arrangements to cover small, numerous institutions that pose low systemic risk in some jurisdictions."*

6.1.2 Preferred frequency of reporting to regulator

In our discussion with MFIs, we found that the submission of returns did not seem to be a major issue with the Tier III and Tier IV institutions as the MFI Bill is yet to be passed. This point was emphasized when we interacted with smaller NBFCs and MFIs registered as Section 25 companies. (the smaller MFIs and the institutions which were new and registered as either Section 25 or as a trust and/or a society may have lighter regulations initially and can be brought under tighter norms as they grow and became more systemically important). Trusts and societies preferred to submit returns and other documents less frequently compared to NBFCs; NBFC-MFIs (that were waiting to be registered) felt that the current regulations on reporting and inspection were adequate and preferred submitting returns either monthly or quarterly as can be seen from Table 2.

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* Micro Finance Activities and Core Principles for Effective Banking Supervision August 2010, page 1
* Micro Finance Activities and Core Principles for Effective Banking Supervision August 2010, page 4

Table 2: Preferred frequency of reporting by MF institution (according to legal structure)

Tier	%of Institutions	Frequency of Submission of Returns
Tier 2	26.53	Monthly
Tier 3	14.28	Quarterly
Tier 4	59.18	Half-yearly or Yearly

According to Principle 21 (Supervisory reporting), "the effectiveness, timeliness, quality and costs of off-site surveillance and on-site inspections will depend on implementation of Principle 21 which should be tailored to ODTIs in a manner that is commensurate with the type and size of their transactions … in a way that requirements do not unduly increase costs of microfinance activities … The content of reports and their frequency must be strictly aligned to the specialized analyses that are needed for effective supervision. Participation in credit bureaus should be required of all supervised microfinance providers" [*](hence, it is not required for non-supervised MFIs).

6.1.3 Preference of regulators among MFIs

All the non-NBFC-MFIs preferred to be regulated by NABARD, or by an MFI funder, or by some other regulatory organization. About 75% of the MFIs who were NBFCs preferred to be regulated by the RBI, while the remaining thought NABARD would be more suited to regulate them (Table 3).

[*] Micro Finance Activities and Core Principles for Effective Banking Supervision August 2010, page 4

Table 3: Current vs. Preferred Regulator of MFIs

Tier	**%of Institutes**	**Current Regulator**	**Preferred Regulator**
Tier 2	26.53	RBI	RBI
Tier 3	14.28	Companies Act	NBFC Funders(Ananya and Sadhan)
Tier 4	59.18	NBFC Funders	NABARD

According to Clause 33(*1*) of the MFI Bill 2012 (page 14),"The Reserve Bank shall formulate a scheme for redressal of grievances of beneficiaries of micro finance services against micro finance institutions and may entrust the functions of redressal of such 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 would be ideal if the redressal mechanism of the Tier 3 and Tier 4 MFIs were with NABARD as this is their preferred regulator (as shown in Table 3). Perhaps the perceived local touch of NABARD due to its presence at the district level adds to the comfort of these MFIs in dealing with NABARD. Moreover, the redressal of the grievances of MFI customers could be very challenging for the RBI. In 2011–2012, fifteen Offices of the Banking Ombudsman (OBOs) situated across the country received 72,889 complaints about deficiencies in banking services. Taking into account 4,618 complaints that had been pending at the beginning of the year, the OBOs handled 77,507 complaints that year. The OBOs settled 72,885 complaints during the year, clocking a disposal rate of 94%. As of June 30, 2012, 4,622 complaints were pending at the OBOs. If the OBOs have to handle the grievances of the MFIs'clients, the task of the OBOs would extremely daunting. In addition, the OBO are located in the regional office center, while MFIs' clients are in far-flung/remote rural areas. Therefore, it would be a better to have an agency that has reach at the district level to handle the grievances, such as NABARD. The OBOs could perhaps act as the Appellate Authority in such cases.

6.1.4 Securitization and selling of portfolios to banks

Almost all the NBFCs and Section 25-registered MFIs that were interviewed securitized their loans. While MFIs of societies and trusts did not securitize their loan portfolios, the MFIs that were small and in remote rural areas had no awareness about securitization. As far as selling their loan assets to banks (as part of priority sector lending targets for the banks) is concerned, there seemed to be no pattern according to the type of MFI.50% of all NBFCs sold their portfolios to banks, while the remaining did not. While trusts and NBFCs sold their portfolios, the Section 25 companies and societies did not. The reason for this could be lack of awareness among trusts and societies in the rural areas or apprehension on the part of the relatively newer MFIs in selling their portfolios.

In addition, the NBFC-MFIs who securitized their loans talked about a proposal in the RBI Guidelines dated August 21, 2012 (Guidelines on Securitization Transactions),which(though well-intended) has led to some unintended consequences:"In order to prevent unhealthy practices surrounding securitization viz. origination of loans for the sole purpose of securitization and in order to align the interest of the originator with that of the investors and with a view to redistribute credit risk to a wide spectrum of investors, it was felt necessary that originators should retain a portion of each securitization originated and ensure more effective screening of loans. In addition, a minimum period of retention of loans prior to securitization was also considered desirable, to give comfort to the investors regarding the due diligence exercised by the originator."[*]

For loans with original maturity up to two years, the minimum number of installments to be paid before securitization is as follows—weekly repayment: 12; fortnightly repayment: 6; monthly repayment: 3;and quarterly repayment: 2.

Effectively, the MFI's loan tenure is for 50 weeks and hence, it can be securitized only after three months (12 weeks). This means an investor would be looking at a very short-term instrument that runs for 36–38 weeks.

[*]DNBS. PD. No. 301/3.10.01/2012-13 dated August 21, 2012

On March 16, 2011, the SEBI permitted the listing of securitized debts. However, even if an MFI lists its securities, it could only be for 36–38 weeks. It is highly unlikely that any investor would be willing to invest in such a short-term security.

On July 1, 2012, the RBI stated that "banks should not invest in Non-SLR securities of original maturity of less than one-year, other than Commercial Paper and Certificates of Deposits…and NCDs with original or initial maturity up to one year issued by corporates (including NBFCs)".[*]

Hence, commercial banks are not in favor of investing in securitized papers of MFIs. This stifles the MFIs, which need liquidity for their operations.

6.1.5 Taxation-related issues

The MFIs (such as Trusts and Societies) receive funds for furthering their social/charitable activities such running an old-age home, orphanage, schools for spastic children, and so on; they are also involved in microfinance activity. These institutions are taxed by the Income Tax Department for business activity (for the microfinance activity) as they have not bifurcated their accounts between the use of funds for microfinance and other activities. Further, these institutions have been asked to remit tax arrears for several years.

6.1.6 Gold loan companies

Gold loan companies (GLC-NBCFs) seem to have an advantage over NBFC-MFIs. A GLC operates like an MFI but the NBFC-MFI circular does not cover these companies. Thus, GLCs have an edge over NBFC-MFIs and MFIs seem to be losing business to GLCs since the playing field is not level**.**

[*] DBOD No. BP. BC.13/21.04.141/2012-13 July 1, 2012

6.2 Regulation from client's perspective

6.2.1 Change in legal status

Almost all the NBFCs we spoke to expressed their desire to register after the draft Microfinance Regulation has beenpassed.87.5% of all the NBFCs also said that they would like to convert to an NBFC-MFI after the Bill is passed. All the societies and trusts also wished to register after the draft Microfinance Regulation is passed, but did not want to convert to NBFC-MFIs and preferred to retain their legal status; they felt that they should serve the bottom of the pyramid and were not at all profit oriented.

Regarding net owned funds (NOF), the Bill requires all MFIs to obtain a certificate of registration from the RBI. The applicant needs to have an NOF of at least INR 5 lakh. By NOF, the Bill means the aggregate of paid-up equity capital and free reserves on the balance sheet (Clause 15). The RBI December 2011 circular provides an 'Entry Point Norm' for an NBFC-MFI: it should have a minimum NOF of INR 5 crore. Would it not be a risky proposition to permit MFIs under the Bill to only have a meager NOF of INR 5 lakh and yet be allowed to obtain 'thrift' from the vulnerable section of the society, without deposit insurance cover?

6.2.2 Pricing of credit under RBI regulations

On December 2, 2011, the RBI introduced a new category of NBFCs—non-banking financial company-microfinance institutions (NBFC-MFIs); consequent to the representations of the NBFC-MFIs, the RBI slightly modified some aspects of certain provisions on August 3, 2012. This is a great move by the RBI and counts as recognition for the MFI as an industry/asset class. This historical step would put the MFIs on a growth path, and would enable rapid financial inclusion; the MFIs would be an enabler in this cause.

However, this regulation causes anxiety among the MFIs and investors as it would be quite a while before the real implication of the clause is assessed. This would also increase the compliance cost of the MFIs as they have to maintain additional records to ensure this norm is not violated, especially since MFIs source funds from various institutions.

6.2.3 Income generation criteria under RBI regulation

There are practical issues in the implementation of this aspect of the regulations as the end use of the funds are difficult to verify given the volume of loans (small-ticket loans) of the NBFC-MFIs. To satisfy the RBI mandate, MFIs would simply obtain a declaration that the borrower would use the loan amount for income-generation activity—the purpose for which the loan is granted. If NBFC-MFIs were to verify the end use, it would only add up to the cost of compliance. According to the BCBS,–"supervisors should set loan documentation standards that are efficient and feasible to maintain relative to the nature of the customers and their businesses, which may differ from those of conventional retail lending" (Principle 8: Credit risk).[*]

6.2.4 Income criteria under RBI regulations

NBFC-MFIs lend mostly to people in the unorganized sector; hence, ensuring that their household income is within the specified limits would be an uphill task. In the absence of reliable documents for assessing the income of the borrowers, the MFIs would probably resort to obtaining a declaration, whereby the requirement would be complied with in letter only. Further, the income of the members would have gone up beyond the threshold levels due to the borrowings in subsequent cycles. Therefore, if this condition were made applicable to subsequent cycles of loans, it would make the borrower ineligible.

The other detailed issues that the MFI regulator or the SEBI might want to revisit are discussed in Appendix 3; issues related to MF that were raised by some recent committees are also discussed.

7. Conclusion

The RBI does agree that NBFC-MFIs have a role to play in the financial inclusion (FI) agenda and contribute in no small measure in serving the bottom of the pyramid. If some of the regulations can be revisited, it would enable the MFIs to contribute further to the FI cause. India has over 6 lakh villages; it would be impossible for the country to have 6 lakh bank branches.

[*] Microfinance activities and the Core Principles for Effective Supervision

NBFC-MFIs would serve as last-mile connectivity if they are properly nurtured and developed in the marathon task of FI. The regulators have a role in protecting the interest of the bottom-of–the-pyramid borrowers and depositors and a developmental role as well. If FI is to be brought about only by mainstream institutions, the waiting/gestation period would be very long. Instead, if the FI agenda is to be achieved in the shortest period possible, the MFIs and markets have to be involved. Hence, to speed up both access and off take of finance to the base of the pyramid, we feel that the following features need to be revisited.

Microfinance oversight should weigh the risks posed by this line of business against supervisory costs and the role of microfinance in fostering financial inclusion. The same analogy could be extended to non-deposit-accepting MFIs as well (more so since they do not accept deposits from the public);they should be subject to regulation and supervision commensurate with the size of their transactions rather than form. Size, not structure, should matter when considering the regulation of an institution. We also feel that the redressal mechanism of these MFIs can be best handled by NABARD. However, the RBI OBO can be the Appellate Authority.

It would be very enabling if the securitization guidelines were modified to enable NBFC-MFIs to securitize and list their securities. The divergence in the definition of microcredit between the MF Bill 2012 and the RBI Guidelines to NBFC-MFIs issued in December 2011 must be reconciled to give better clarity to the sector.

It would be a risky proposition to permit MFIs under the Bill to only have a meager NOF of INR 5 lakh and yet allow them to obtain thrift from the vulnerable section of society without a deposit insurance cover. MFIs with a meager NOF either should not be permitted to accept thrift or may be permitted to do so with a deposit insurance cover to the clients. The RBI regulations regarding the pricing of credit should be revisited to provide flexibility to MFIs in their operations. The criteria—such as 75% income generation in the case of qualifying asset, income criteria for borrowers, geographical diversification, and so on—should be decided by the market players; otherwise it would stifle the operations of the MF institutions.

Foreign institutional investors (FIIs) have been allowed to invest in unlisted debts of corporates in the infrastructure sector in India. If this notification were extended to MFIs, it would enable them to raise debt funds. MFIs should also be allowed to raise external commercial borrowing(ECB) at market determined rates. On November 6, 2012, the RBI permitted SIDBI to raise ECBs for on-lending to micro, small, and medium enterprises (MSMEs). If such a dispensation could be thought about for MFIs, it would go a long way in addressing their needs for low-cost funds, particularly for smaller MFIs.

To establish a bank branch in each of the 6 lakh villages in India is unfeasible as it would be unviable. Raising resources externally has its own limitations. Such resources could be short-term, lumpy, and highly volatile. There are enough financial resources available within the country and the poor have demonstrated that they do save. We need to mobilize these resources in a cost-effective way. Through the market model, MFIs could be a cost-effective one; this could be a win-win situation for the country where FI is at the top of the agenda of every regulator. Once we reach this stage, we would have no problem in enacting the law for making access to finance/financial services a fundamental right or at least a directive principle of the state policy. Markets and market participants have a major role to play in this regard.

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3. A.P. (DIR Series) Circular No. 55 dated April 29, 2011
4. A.P. (DIR Series) Circular No.40 dated October 09, 2012
5. A.P. (DIR Series) Circular No.48 dated November 6, 2012
6. DBOD No. BP. BC.13/21.04.141/2012-13 dated July 1, 2012 (Master Circular)
7. DNBS (PD) CC No. 279 / 03.02.001 / 2012-13 July 2, 2012 (Master Circular on Prudential Norms)
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19. SEBI/ CIR/IMD/DF/2/2011 dated March 16, 2011Press Release PR No. 40/2012 April 2, 2012
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22. SEBI/OW/16541/2012 dared July 24, 2012

Appendix 1

Questionnaire: Microfinance Products and Regulation

1. Are you registered with any statutory body (RBI/ NABARD/IRDA/SEBI/Others)?
   a) Yes   b) No
2. Does the statutory body with which you are registered require any reporting?
   a) Yes   b) No
3. Is your organization currently inspected by any statutory body for the delivery of financial services?
   a) Yes   b) No
4. If yes, which one and when?
5. Do you think the microfinance industry should be regulated?
   a) Yes   b) No
6. Please state the reasons for your answer in (5).
7. Who according to you should be the regulator?
   a) RBI
   b) SEBI
   c) NABARD
   d) Donors
   e) Other (please specify)
8. How often should the regulator mandate the submission of returns?
   a) Every month
   b) Every quarter
   c) Every year
   d) Other(please specify)
9. What information would you be willing to provide to the regulator?
   a) Financial statements
   b) Audited accounts
   c) Cash flow projections
   d) Donor inflows/investments
   e) Organizational operation manuals

f) Other (please specify)

10. According to you, how often should you report to the regulator?
    a) Every month
    b) Every quarter
    c) Every six months
    d) Every year
    e) Other (please specify)
11. From your institution's experience, what are the major regulatory-related and supervisory-related obstacles to the provision of financial services relating to the securities markets?
12. What the major non-regulatory and supervisory obstacles faced by your institution in the provision of financial services that the securities markets can help with?
13. Do you securitize your loans and advances (credit facilities)?
    a) Yes b) No
14. Are your securitized loans and advances (credit facilities) listed?
    a) Yes b) No
15. If your answer in (14) is "No", please state the reasons for your answer.
16. Do you sell your loan portfolio to enable banks to meet priority sector targets? Substantiate.
17. Do you plan to register your organization after the draft Microfinance Regulations Bill is passed?
    a) Yes b) No

    Please give reasons………………………………
18. Are you planning to convert your institution into an NBFC-MFI after the Microfinance Regulations Bill is passed?
    a) Yes b) No

    Please give reasons………………………………

Appendix 2

List of Institutions Related to MF Activities in TN that were studied

Sl. No.	List of Institutions	Status
1	Arasan Rural Development Society (ARDS)	Society
2	Asirvad	NBFC
3	Association for Rural Community Development (ARCOD)	Society
4	Activist for Social Alternatives (ASA)	Trust
5	Bullock-cart Workers Development Association (BWDA)	Society
6	BWDA Finance Limited (BFL)	NBFC
7	Community Action for Rural Development (CARD)	Society
8	Community Development Centre	Trust
9	Community Service Trust	Society
10	Ecumenical Church Loan Fund of India (ECLOF)	Section 25 Company
11	Equitas Microfinance India Private Limited	NBFC
12	Guidance Society for Labour Orphans & Women (GLOW)	Society
13	GramaVidiyal Microfinance Limited (GVML)	NBFC
14	Growing Opportunity Finance	NBFC
15	Hand in Hand	Trust
16	Impact (World Vision)	Section 25 Company
17	Indian Association for Saving & Credit (IASC)	Section 25
18	Integrated Village Development Project (IVDP)	Society
19	Kalanjiam Development Financial Services (KDFS)	Section 25 Company
20	Kalrayan Hills ADP (KHADP)	Society
21	League for Education & Development (LEAD)	Society
22	Madura Microfinance Limited	NBFC
23	Mahalir Association for Literacy, Awareness and Rights (MALAR)	Society
24	Mahasemam Trust	Trust
25	Micro-finance Consulting Group (MCG)	NBFC
26	ManidhamGrameen Savings & Credit Services (MGSCS)	Section 25 Company
27	Nanayasurabhi Development Financial Services (NDFS)	Society
28	NEW LIFE	Society
29	The Society for Development of Human Abilities and Environment (OAZOANE)	Society
30	Omalur Block Women Welfare Uplift Organisation (OBWWUO)	Trust
31	Pioneer Trad	Society
32	PREPARE	Society
33	People's Action for Transformation	Trust
34	People's Action for Development and Credit Union	Trust

Sl. No.	List of Institutions	Status
	(PADACU)	
35	People's Voluntary Integral Service Organization	Section 25 Company
36	PudhuaaruKhasthriyaGramin Financial Services	NBFC
37	Rural Education & Action Development (READ)	Society
38	Rural Organization For Action and Development (ROAD)	Trust
39	SEARCH-KOPSA	Section 25 Company
40	Sarvodaya Nano Finance Ltd (SNF)	NBFC
41	Senam Micro Finance Investment Literacy & Empowerment Ltd. (SMILE)	NBFC
42	Serva Jana SevaKosh Ltd. (SJSK)	NBFC
43	Sangamam Women's Multipurpose Thrift and Credit Co-operative Society Ltd	Society
44	Shalom Trust	NBFC
45	Suryodaya	NBFC
46	Thirumalai Charity Trust (TCT)	Trust
47	Welfare Organization for Multipurpose Mass Awareness Network (WOMAN)	Society
48	Working Women's Forum (WWF)	Society

Appendix3

Issues that the MFI Regulator could revisit

1. Geographical diversification

MFIs by their very nature have niche geographical areas; mandating them to spread their risk across the country may be counterproductive. If this is not what was intended (spreading across various states), the Regulation has to be more specific and clear, probably by including an example. According to the BCBS**(**Principle 10: Large exposure limits*)*,there should be“regulatory limitations on exposures … without unduly penalizing otherwise sound practices”. According to K. C. Chakrabarty (Deputy Governor, Reserve Bank of India),“microfinance institutions (MFIs) should scale up their operations develop local expertise and scale up locally. They should not scale up nationally.”(Some thoughts: RBI Deputy Governor K. C. Chakrabarty delivering his lecture at a conference on corporate governance in microfinance organised by the Indian Chamber of Commerce in Kolkata,February 16, 2013 Business Line)

2. Know your Customer (KYC)

Under the KYC Registration Agency Regulations, 2011 (KRA Regulations), the SEBI stipulated that the KYC Registration Agency (KRA) will maintain the Know your Customer (KYC) records of the investors centrally, on behalf of capital market intermediaries, which would prevent duplication and inconvenience to investors. This would also enable a single-point change management. Once the client has done KYC with a SEBI-registered intermediary, the client need not undergo the same process again with another intermediary. A similar dispensation for MFI clients (with connectivity available for interfacing banks/MFIs/insurance network) would reduce the KYC difficulties faced by clients.

3. Equity

The RBI-mandated capital norms are applicable to NBFC-MFIs, which seems to be divergent from the MFI Bill, 2012. It would make sense for investors to invest a smaller amount in non-NBFC-MFIs (INR 5 lakh) than to invest in the NBFC-MFIs (INR 5 crore), and diversify the risk if the returns on both forms of MFIs were the same.

As the IPO route for raising equity capital is rather difficult due to the poor valuations for corporate MFIs at present, the alternative for MFIs would be to look for private equity(PE). In April 2012, SEBI introduced the Regulation of Alternative Investment Funds (AIF**)** (PR 40/12), which covers private equity investments. PE funders are still trying to understand the implications of the circular, and hence, are reluctant to take a call at present; consequently, PE for the MFI sector had slowed down.

4. Prudential norms for NBFCs: Tier 2capital

While permitting NBFCs to raise "subordinated debt" (RBI Prudential Norms Circular dated July 2, 2012), the RBI has said that this should be by means of an instrument and the book value of this instrument should be subjected to discounting of 20%every year.

According to this stipulation, NBFCs lose the utility of Tier 2capital for the full term after the fifth year, but are required to pay interest for the full period of the subordinated debt. This adds to the cost of funds. In addition, since the word "instrument" is used, NBFCs have to necessarily issue the debt either as a bond or debenture, which attracts stamp duty of 1–10%, depending on the respective State Act. NBFCs could instead be permitted to raise the same as locked-in debt.

5. Debt: Bonds, non-convertible debentures

The SEBI and the RBI (on November 26, 2010 (para 8) and March 1, 2012, respectively) permitted FII investment in debt securities that were committed to be listed on stock exchanges. However, the RBI on April 29, 2011 allowed SEBI-registered FIIs to invest in unlisted non-convertible debentures/bonds issued by corporates in the infrastructure sector.

Corporates in the infrastructure were preferred by the regulator owing to the importance of the sector. If this notification were extended to MFIs, it would enable them to raise debt funds.

6. Bank borrowing

On May 3, 2011,theRural Planning &Credit Department of the RBI specified that bank credit to microfinance institutions extended on or after April 1, 2011 for on-lending to individuals and also to members of SHGs/JLGs would be eligible for categorization as priority sector; certain conditions were specified for this categorization.

Given the risk perception of the MFI industry at present, which was accentuated by the AP MFI crisis, banks continue to view the sector with skepticism and are yet to take a final view on the social benefits that the sector provides to millions of under-privileged people. The RBI could perhaps impress upon banks to lend to the MFI sector as it did during the earlier crisis.

7. External commercial borrowings (ECBs)

MFIs are permitted to raise ECBs (RBI Master Circular No.12/2012-13 dated July 2, 2012 and Circular dated October 09, 2012) with the stipulation that the all-in-cost ceiling is350 basis points over six months LIBOR for ECBs between three and five years maturity and is 500 basis points for more than five years maturity.

Permitting MFIs (including NBFC-MFIs) to raise ECBs would go a long way in enabling the raising of funds by MFIs. This is a great step taken by the RBI. However, foreign investors are quite apprehensive about the returns, given the risk perception about the MFI sector in India. It would be best if the all-in-cost norm is decided by the market, as this could enable the MFIs to raise funds at a much lower price than from the sources within the country.

Incidentally, the RBI permitted SIDBI to raise ECBs for on-lending to MSMEs (on November 6, 2012). If such a dispensation could be thought about for MFIs, it would go a long way in addressing their need for low-cost funds; even though smaller MFIs are permitted to raise ECBs, they may not be inclined to do so considering the hedging and related requirements.

8. Distribution of other financial products

The RBI DNBS Master Circular dated July 1, 2012 stipulated that NBFCs could market and distribute mutual fund products as agents of mutual funds with the prior approval of the RBI for an initial period of two years and a review thereafter, with a condition that the minimum net owned fund should be INR 100 crores.

This is a deterrent for NBFC-MFIs; contributing towards the financial inclusion of the under-privileged would not put them in a position to bring in INR 100 crore as NOF. Hence, hardly any NBFC is engaged in this business at present. Assuming that mutual funds are a good proxy for a thrift product that MFIs cannot offer, the high eligibility requirement (INR 100 crore) cannot be met by most of the NBFCs. Principle 7 of the BCBS echoes similar sentiments.

9. Policy and regulatory convergence

The Working Group on the Issues and Concerns in the NBFC Sector (August 2011)talked about the need for bringing in policy and regulatory convergence between banks and NBFCs to minimize regulatory arbitrage opportunities(UshaThorat Committee Report). The Financial Sector Assessment Handbook—2009 recommended that bank and financial institutions that provide similar products/services should be regulated similarly.

Though the RBI has not come out with any specific circular in this regard so far, this has created apprehension in the minds of investors and others regarding what the regulations could be in the future. NBFCs and MFIs believe that in the future, the regulations could probably become more stringent as they would have to be regulated like banks in accordance with the committee's recommendations. This has created anxiety in the minds of investors.

Issues that SEBI could revisit

1. Cash investments up to INR 50,000

On August 16, 2012, the SEBI allowed cash transactions upto INR 20,000 in mutual fund schemes for small investors.

This move is significant, making it easier for those in the unorganized urban and rural areas to invest. Cash investments are aimed at those investors who would typically invest in micro systematic investment plans (SIPs). Micro SIP is a facility that allows one to invest up to INR 50,000 a year. Targeted at the weaker sections of society, micro SIPs do not require investors to submit their permanent account number (PAN). If the market regulator were to provide a clarification that the norm is applicable to both the deposit as well as the withdrawal of MF investments, the objective of the SEBI would be fully met.

In addition, SHGs/societies and local organizations should be allowed to accept cash on behalf of their members. These members, who are mostly from the economically weaker sections of the society and are daily wage workers, do not necessarily have bank accounts but still wish to set aside a small sum (say INR 100–200) every month towards savings/investment. The organization could pool in all the money and invest the cash (perhaps in the form of a single cheque) to an

AMC that would then invest this money in one of its schemes. A clarification from SEBI in this regard would be quite useful.

2. Permanent account number (PAN)

Addressing the Association of Mutual Funds in India (AMFI), the SEBI exempted micro financial products from the need for PAN (on July 24, 2012). Hence, investments in mutual fund schemes/plans (including investments in SIPs upto INR 50,000 per investor per year per mutual fund) would be exempted from the requirement of PAN.

This is an excellent step taken by the regulator, which would boost investments in mutual funds by people with limited means of income and micro savings.

3. Debt segment on stock exchanges

With the objectives of developing corporate bond markets and encouraging trading on the stock exchange trading platform, the SEBI created a separate debt segment on stock exchanges (on January 18, 2013), which will facilitate scheduled commercial banks, primary dealers, pension funds, provident funds, insurance companies, and mutual funds in becoming members for the purpose of undertaking proprietary transactions in the corporate bond market.

This is a very significant move by the SEBI, and would deepen the debt segment of the corporate bond market. This would enable small investors to invest in the bond market through the MF and other routes, and further the cause of financial inclusion.

General observations related to various committee reports

1. According to the Report of the Committee on Financial Sector Reforms (Raghuram Rajan Committee, September 2008),"Any registered lender (including microfinance institutions, cooperative banks, banking correspondents, etc.) who has made loans to eligible categories would get 'Priority Sector Lending Certificates' (PSLC) for the amount of these loans."This recommendation was reiterated by the M.V.Nair Committee in February 2012. The RBI ought to consider permitting PSLC as recommend by these two committees.
2. According to the Raghuram Rajan Committee Report (2008),"excessive regulatory micromanagement leads to a counter-productive interaction between the regulator and the

regulated. The regulated respond to the needs and opportunities in the marketplace while attempting to comply only with the letter of the law. The regulator then attempts to stamp out violations of the spirit through new rules and the regulated find new ways to get around them."

3. According to the Raghuram Rajan Committee Report (2008), "Despite its success, the future growth of microfinance is constrained by a number of factors. An important issue is the ability of MFIs to raise financing. Given the large estimated demand for microcredit, MFIs need multiple sources of financing, apart from the traditional loan financing from banks. Other constraints include an unclear regulatory environment and the lack of well-developed management information systems and an adequate supply of trained management talent to facilitate sustainable scaling up."
4. The regulators should create an environment congenial to enabling MFIs to function efficiently and effectively. According to the Raghuram Rajan Committee Report (2008),"Any comprehensive and sustainable response to addressing issues of financial inclusion must necessarily factor in the role of the market. This is because efficiency, innovation and cost-effectiveness are key to serving the financial needs of the poor. The financial sector does not ignore the poor because of biases, but because the transaction costs in serving them are high. Initiatives that reduce these costs will allow service providers to begin thinking of financial services for the poor as a business opportunity and not as an act of charity. Policy initiatives need to make financial services for the poor as attractive as those for the rich, and increase competition to serve them. To reduce transaction costs, public policy must facilitate the use of technology and the creation of low cost organizational structures to reach the poor."
5. According to the Working Group on the Issues and Concerns in the NBFC Sector (UshaThorat Committee Report and Recommendations, August 2011,para 3.1.4),"the Working Group proposes that small non deposit taking NBFCs with assets of Rs.50 crore or less could be exempt from the requirement of RBI registration. Not being deposit taking companies and being small in size, no serious threat perception is perceived to emanate from them. This would at the same time also reduce the cost of regulation. Such a measure would not prevent small but potentially dynamic and innovative start up companies from entering the area of financial activity. In fact, it might incentivise such

companies to increase their capital and assets to the minimum levels that would allow them to get registered over a reasonable period of time."

Hence, smaller MFIs should be exempt from registration and regulation as this move would be beneficial to the Regulator as well as the MFIs. As mentioned earlier, Tier I MFIs could be regulated while exempting Tier II, Tier III, and Tier IV MFIs from registration.

6. The following excerpt is from the Report of the Review Group on the Working of the Local Area Bank (LAB) Scheme (para 3.4):"At the outset, it needs to be emphasized that these banks have been in existence only for a short period thus ruling out a definitive pronouncement on their success or failure. Obviously, these banks will need a little more time to establish themselves firmly in the areas in which they are functioning and win the confidence of both the investors and the borrowers."

   Further, the Report mentions the following (para 3.19):"To facilitate the development of the existing LABs into viable commercial units we feel that it will be appropriate to extend them special treatment in certain respects. Access to refinancing facility will be one such avenue. At present LABs are not eligible for drawing refinance from NABARD and SIDBI as they are not scheduled Banks. The absence of refinancing facility places the LABs under a serious handicap both in managing maturity mismatch and in their ability to lend at finer rates."

   LABs may be the perfect solution as a vehicle for financial inclusion—they combine the kind of local knowledge presumed to be the special feature of cooperatives with the professional ethos of a commercial bank. Like commercial banks, LABs are licensed, supervised, and regulated by the RBI. It would be worthwhile to revisit the concept of LABs and examine whether these institutions can be used for financial inclusion, as the RBI feels that financial inclusion is to be brought about by mainstream institutional players.

7. Finally, to quote Dr. K.C. Chakrabarty, Deputy Governor, RBI (speech delivered at the 27th National Conference of the AIBEA at Kochi, onFebruary 9, 2013): "Out of the 600,000 habitations in the country, only about 36,000+ had a commercial bank branch … Just about 40% of the population across the country had bank accounts… The proportion

of people having any kind of life insurance cover was as low as 10% … People having credit cards [constituted] only a marginal 2% of the population.”

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