



## Regulation of Microfinance Institutions in India

*Considering the importance of microfinance institutions in fulfilling the goals of financial inclusion, it is essential to understand the body of laws, rules and regulations which govern this financial tool. Following the aftermath of the Andhra Pradesh microfinance issue and the subsequent rise of the microfinance industry nevertheless, various prudential and non-prudential norms were evolved by the regulatory bodies in the country in order to effectively regulate microfinance institutions. However, an overlap between the areas dealt with by various authorities governing microfinance entities on critical issues like interest rate determination create uncertainty on the basic conditions of thriving in this sector for participant institutions. This briefing paper deals with some of the problems in regulation of microfinance institutions and presents solutions which should be taken into consideration.*

### Introduction

Microfinance institutions (MFIs) perform a crucial function of facilitating financial inclusion goals in developing countries through the provision of micro-finance services. Micro-finance services include: (a) micro-credit facilities to the extent of ₹05lac [or ₹10lac if so specified by the Reserve Bank of India (RBI)]; (b) the collection of thrift; (c) pension; (d) insurance services; and (d) the remittance of funds to individuals within India subject to prior approval by the RBI.

MFIs in India have grown tremendously in terms of size, outreach, and financial maturity since their emergence in the 1980s. Recent RBI reports with regard to microfinance activities state that alongside self-help group (SHG)-bank linkage programmes, MFIs, such as non-government organisations (NGOs) and non-banking finance companies (NBFCs) have emerged as important sources of microfinance delivery in India. Consequently, incentives have been provided for penetration of banking into unbanked areas and encouraging MFIs as intermediaries. However, the growth of the MFIs has been geographically disproportionate. The

Malegam Committee report noted that distribution of microfinance penetration is more than half of the total MFI portfolio of India in the Southern region while the Eastern region has over one fourth of the total MFI portfolio.

This briefing paper presents a picture of the regulatory instruments governing different microfinance entities in the country. Specific features of regulation of NBFC-MFIs, and the current state of the conflict between State Money Lending institution actors and the RBI has been captured. Prudential and non-prudential norms of regulation and their consequent impact on competition have been dealt within this paper.

### Regulation

#### Legal Structure of MFIs:

A microfinance institution under the Microfinance Institutions (Development and Regulation) Bill, 2012 includes the following entities: (a) a society registered under the Societies Registration Act, 1860; (b) a company registered under section 3 of the

Companies Act, 1956; (c) a trust established under any law for the time being in force; (d) a body corporate; or (e) any other organisation, which may be specified by the RBI if the object of the institution is the provision of microfinance services. It does not include a banking company, co-operative societies engaged primarily in agricultural operations or industrial activities or any individual who carries on the activity of money-lending and is registered as a moneylender under the provision of any State law.

A MFI in India acquires permission to lend through registration (Table 1 provides details of the registration requirements). MFIs are registered as one of the following five types of entities<sup>1</sup>:

1. Non-Government Organisations engaged in microfinance (NGO MFIs), comprising of Societies and Trusts;
2. Cooperatives registered under the conventional state-level cooperative acts, the national level Multi-State Cooperative Societies Act (MSCA 2002), or under the new State-level Mutually Aided Cooperative Societies Act (MACS Act);
3. Section 25 Companies (not-for profit);
4. For-profit NBFCs; and
5. NBFC-MFIs.

Table 1 tabulates the major regulations applicable to NBFCs as stipulated by the RBI. Major regulatory aspects include priority sector lending, deposit mobilisation, access to capital, the Money Lending Act, and state level regulations.

*Priority Sector Lending:* Priority sector lending is a government initiative which requires banks to allocate a percentage of their portfolios to investment

in specified priority sectors at concessional rates of interest. Currently only MFIs registered as NBFC-MFIs are designated as a priority sector. The number of priority sectors has recently been reduced, which suggests that banks will be relying more heavily on lending to MFIs to meet the priority sector requirements.

In order to register as a NBFC-MFI, an institution must meet requirements specified by RBI. RBI requires that a minimum of 75 percent of a NBFC-MFI's loan portfolio must have originated for income-generating activities. Additionally, an NBFC-MFI must have 85 percent of its total assets as qualifying assets (excluding cash, balances with banks and financial institutions, government securities and money market instruments). A qualifying asset is a loan which meets the following criteria:

1. Borrower's household annual income does not exceed ₹60,000 or ₹1,20,000 for rural and urban areas respectively.
2. Maximum loan size of ₹35,000 (first cycle) and ₹50,000 (subsequent cycles).
3. Maximum borrower total indebtedness of ₹50,000.
4. Minimum tenure of 24 months when loan exceeds ₹15,000.
5. No prepayment penalties.
6. No collateral.
7. Repayable by weekly, fortnightly or monthly instalments at the choice of the borrower.

*Deposit Mobilisation:* Regulation stipulates that only NBFCs and Cooperatives are permitted to accept public deposits, though NBFCs must adhere to additional stringent regulations,<sup>2</sup> and Cooperatives are only permitted to accept deposits from its members. There also exists what is called a deposits limited for NBFCs linked to the institution's Net

Owned Fund (NOF). No MFI registered as an NBFC currently accepts deposits because regulation requires that institutions must obtain an investment grade rating, which no MFI has obtained so far.

*Access to Capital:* MFIs in theory can raise capital through various methods, including borrowing from domestic and foreign debt markets, obtaining grants and loans from subsidised lending funds, attracting foreign equity investment from capital markets, though legal structure of MFIs restrict capital acquisition from some of these sources.

**Table 1: MFIs by Type of Registration**

Category	Type of MFI	Registration
Not for Profit	NGO MFIs: Societies & Trusts (500)	Registered under Societies Registration Act, 1860 and / or Indian Trust Act 1882
	Section 25 Companies (10)	Section 25 of Companies Act, 1956
Mutual Benefit	Cooperatives (100)	Registered under State Cooperative Societies Act or Mutually Aided Cooperative Societies Act (MACS) or Multi-State Cooperative Societies Act, 2002
For-Profit	NBFC (50)	Companies Act, 1956 & registered with RBI
	NBFC-MFI	RBI Circular, May 2011

Source: M-CRIL Microfinance Review 2010, <http://www.m-cril.com/Backend/ModulesFiles/NewsEvents/M-CRIL-Microfinance-Review-Nov2010.pdf>

NBFCs can receive both equity and debt investments. They can raise foreign equity investment, though a minimum investment restriction requirement of US\$500,000 applies, also with a cap of no more than 51 percent stake in the institution. Grants and subsidised onward-lending funds from domestic and foreign sources are not restricted, provided that the foreign grants do not exceed the ceiling of US\$5mn per year.

*Money Lending Act:* The Indian Moneylenders' Act 1918 has been adapted by various state governments to restrict interest rates charged by moneylenders. Although the primary purpose of this act is to protect the vulnerable section from usurious interest rates that moneylenders charge, some states have applied the act to Societies and Trusts also to restrict their lending activity. Other states have applied the Money Lending Act to other forms of MFIs.

*State Level Regulation:* In late 2010, the Andhra Pradesh government enacted the Andhra Pradesh Micro Finance Institutions (*regulation of money lending*) Ordinance, which was later enacted in to Act, to regulate the activities of MFIs. The Act stops MFIs from collecting old loans and originating new loans until the institution registers with the district authorities where they operate. The Act also mandates an interest rate cap such that the total interest charge cannot exceed the principal amount of the loan. The Act also entrusts a great deal of discretionary power to the registering authorities and imposes restrictions on collection practices.

#### *Regulation by the RBI and Money Lenders Legislations*

Microfinance entities have approached the courts to resolve the issue of 'dual regulation'<sup>3</sup> by the RBI and under the State Level Money Lenders Legislations. These microfinance entities contend that an NBFC engaged in microfinance operations, if it has registered itself under RBI norms, should be exempt from registration under the state money-lending norms. This is because certain aspects pertaining to the functioning of the NBFCs such as procuring a licence, the regulation of 'levy of interest' and rate of levy of interest would be subject to dual regulation if exemption from state-money-lending legislations is denied.

State-wise, there are two questions which have to be answered to predict whether the issue of conflict between a State Money Lenders Act, and the RBI norms will be resolved in the same fashion: the issue of dual regulation, and specifically, whether RBI

norms (such as the Fair Practices Code) will encompass the regulation of interest by the RBI. The second facet is critical in determining the profitability of operation because the interest rate prescribed by State Level Money Lending legislations is so low as to render the enterprise unviable.

The High Court of Kerala opined that the RBI Act and the State Money Lenders legislation dealt with two different spheres and no exemption could be granted to entities which were registered under either legislation. On the contrary, an attempt to balance the conflict between state legislations prescribing conditions of levy of interest, and the RBI norms was made by the Gujarat High Court Judgment. Though money-lending may be regulated by a State Act, but an NBFC, as an entity, its operation is dealt with by the RBI. It is only a judgment by the Supreme Court which will dispel prominent doubts over this issue.

The RBI had addressed the issue of interest regulation through the Fair Practices Code and corresponded with the respective state governments to assert that it should be given a clear reign over NBFCs, and to advocate that NBFCs dealing with microfinance operations should be exempt from registration under the State Money Lenders Act. However, certain state governments refused to regard RBI submissions that NBFCs should not be subject to dual regulation by both the Centre, and the State Money Lending legislations. Certain state governments feel that this decision was a matter of State policy.

#### **Policy Initiatives**

Under the Microfinance Institutions (Development and Regulation) Bill, 2012, the Central Government may, by notification, constitute a Council which is known as the Microfinance Development Council to discharge the certain functions under the Act. Apart from this State level Microfinance Councils and District Microfinance Committees are also formed.

In a perception survey, the majority of stakeholders (68 percent) were of the opinion that MFI sector in India needs to be regulated. To control the on-going problem of over-borrowing and unsustainable debt of MFIs, majority of the respondents (63.7 percent) suggested that the creditor should conduct an ability to pay test (know your customer exercise) before extending multiple loans.

## Regulation Tools

### *Regulation of NBFC MFIs*

NBFC MFIs are subject to the following conditions: (i) Minimum NOF of ₹5 crore (if the NBFC is registered in the North Eastern Region of the country, the minimum NOF requirement is Rs2crore) and (ii) not less than 85 percent of its net assets<sup>4</sup> are in the nature of “qualifying assets”<sup>5</sup>. The loan is required to be extended without collateral; the aggregate amount of loans which are given for income generation are not less than 75 percent of the total loans given by the MFIs. The income derived by the NBFC-MFI with the remaining 15 percent of its assets are to be in accordance with the regulations specified in that behalf.<sup>6</sup> An NBFC which is not an NBFC-MFI shall not be permitted to extend loans to the micro-finance sector which exceeds 10 percent of its total assets.<sup>7</sup>

### *Capital Adequacy*

Capital adequacy requirements are used by nearly all countries to reduce the leverage and thus risk of MFIs that are subject to prudential regulation. In India, NBFC-MFIs shall maintain a capital adequacy ratio consisting of Tier I and Tier II Capital which shall not be less than 15 percent of its aggregate risk weighted assets. The total of Tier II Capital at any point of time shall not exceed 100 percent of Tier I Capital.

### *Pricing of Products*

- All NBFC-MFIs are required to maintain an aggregate margin cap of not more than 12 percent.
- The interest on individual loans is not to exceed 26 percent per annum and is to be calculated on a reducing balance basis.
- The processing charges must be less than 1 percent of the gross loan amount. The processing charges are not required to be included in the margin cap or the interest cap.
- When NBFC-MFIs are engaged in the provision of insurance services, the NBFC-MFIs can only recover the actual cost of insurance for the group, livestock, health, for both the borrower, and the spouse. The administrative charges are to be recovered per the IRDA guidelines.

### *Fair Practices in Lending*

- The three components which are taken into consideration in the pricing of the loan are (i) interest charge, (ii) processing charge and (iii) insurance premium. NBFC-MFIs are prohibited from collecting a security deposit/margin from the borrower.

- The effective rate of interest which is charged by the NBFC-MFI will be displayed in all its offices, its website, and the literature issued by the entity.
- NBFC-MFIs are not permitted to collect a penalty on a delayed payment.

### *Other practices*

- A standard form of a loan agreement is required to be used.
- NBFC-MFIs are required to ensure that the modes of recovery are non-coercive. They are required to ensure that a Code of Conduct is implemented which incorporates the principles on Fair Practices as issued for NBFCs vide circular CC No. 80 dated September 28, 2006.
- Multiple Lending, Over-Borrowing and Ghost Borrowers.
- NBFC-MFIs can lend to borrowers who are not members of more than one Self Help Group or Joint Liability Group.
- Not more than two NBFC-MFIs should lend to the same borrower.
- A minimum period of moratorium which is not less than the frequency of repayment should operate between the grant of the loan and the due date of the repayment.

### *Non Prudential Regulations:*

1. *Permission to Lend:* Permission to lend is granted through registration in countries with more advanced regulatory frameworks. Many countries offer a special microfinance window for registration of MFIs, which allow regulation and legislation to be specific to these MFIs. Some countries offer multiple windows to allow for different types of institutions.
2. *Consumer Protection:* Successful consumer protection regulation levels the information gap between institutions and consumers. Regulation must protect consumers and allow for innovation, while not imposing excessive costs. Cambodia, Peru, Ghana, and many countries in Eastern Europe and the former Soviet Union have recently implemented new price disclosure rules that strive to ensure these objectives.<sup>8</sup>
3. *Credit Reference Service:* The great majority of countries believe that credit reference services would improve conditions for both customers and institutions.

It is in the light of limitations of current regulations, the desired regulatory interventions and lessons from a cross-country evaluation of MFI regulation practices that the Microfinance Regulations Bill is evaluated. The Bill includes the following features:

- Designation of RBI as the sole regulator for all MFIs.
- Power to regulate interest rate caps, margin caps, and prudential norms.
- All MFIs must register with RBI.
- Formation of a Micro Finance Development Council, which will advise the central

government on a variety of issues relating to microfinance.

- Formation of State Advisory Councils to oversee microfinance at the state level.
- Creation of Micro Finance Development Fund for investment, training, capacity building, and other expenditures as determined by RBI.

### Competition in the Sector

Table 2 summarises the competition assessment of the microfinance sector in India:

**Table 2: Competitive Analysis**

Factors Impeding Effective Competition	Present Status
1. Barriers to Entry	A company must have Rs5crore NOF (shareholder equity plus internally-generated reserves), to register as an NBFC.
2. Limiting Product Scope	Regulation greatly restricts the type of products that can be offered, particularly relating to deposits. To be able to accept deposits, an NBFC must obtain a specified minimum credit rating (FA from CRISIL, MA from ICRA, BBB from CARE, tA from FITCH), minimum capital adequacy ratio of 15 percent, and two years of completed operations. For qualifying institutions, additional ceiling limits exist based on credit rating. Furthermore, the period of a deposit, payable interest rates, brokerage incentives, and demand deposits are all strictly regulated. Section 25 MFIs are not permitted to take deposits. Due to these restrictions, no MFIs are currently mobilising public deposits. This regulation also restricts other product offerings where MFIs have outstanding obligations to customers, such as insurance or pension products.
3. Barriers to raising finances	RBI's Foreign Investment Promotion Board (FIPB) has set foreign direct investment (FDI) rules for start-up companies not traded publicly on a stock exchange, which includes NBFCs: 1. For FDI up to 51 percent, minimum initial capitalisation of US\$0.5mn 2. For FDI 51 percent-75 percent, minimum initial capitalisation of US\$5mn 3. For FDI 51 percent-75 percent, minimum initial capitalisation of US\$7.5mn and capitalisation of US\$50mn within 24 months 4. FDI above 75 percent is allowed for companies with capitalisation greater than US\$50mn. These restrictions greatly affect investment opportunities for medium and smaller MFIs, which may not be able to attract such large investments.
4. State Government Intervention	Currently, state governments can intervene and enforce additional regulation on MFIs regarding permissible products, methods of collection, and code of conduct. A lack of nation-wide regulatory structure makes the MFI's expansion into multiple states difficult to manage, and much less transparent. A case in point is the recent Andhra Pradesh MFIs Act, 2010. This Act requires all MFIs to register with the Andhra Pradesh government, and subjects them to a number of additional regulations specific only to Andhra Pradesh.
5. Product Transparency	Currently, there are no uniform product transparency requirements that would make institutions provide essential financial information, such as effective interest rate or possible future fees. Product transparency is essential to ensuring fair competition. A customer must be able to access information regarding product benefits and risks, so that institutions' offerings can be compared.
6. Priority Sector Lending	Only select institutions which meet a number of regulatory requirements qualify for priority sector lending. Companies that wish to provide products and services outside the scope of these (narrow) requirements do not qualify for priority sector lending, and thus face significantly higher financing costs.
7. NBFC Status	Many institutions operate as NBFCs for financial and regulatory benefits; however these licenses are greatly restricted by RBI. The licenses are notably difficult to obtain, even if all requirements are met, and many companies end up opting for NBFC status just for the privilege of operating as an NBFC.

## Conclusion and Recommendations:

- Clearly, the current regulatory structure requires reforms, and the Microfinance Regulations Bill seems to meet most of the requirements as can be identified from the cross-country analysis of best practices. It is further important to observe how the issue of dual regulation by the RBI and the States is dealt with.
- Compulsory registration of all institutions engaged in the provision of microfinance services is a positive feature of the bill. However, the current NBFC minimum capital amount (₹5 crore) should not result in creating a barrier to entry.
- Allowing MFIs to engage in deposit taking must be explored as an option.
- Regulation should promote the diversification of funding sources to encourage equity and foreign debt investments. Flexibilities which afford opportunities for smaller institutions to obtain foreign equity investment amount should be inserted into the regulatory framework.

---

## Endnotes

- 1 Status of Micro Finance in India 2009-2010, NABARD, [www.nabard.org/pdf/Status%20of%20Micro%20Finance%202009-10%20Eng.pdf](http://www.nabard.org/pdf/Status%20of%20Micro%20Finance%202009-10%20Eng.pdf). For a detailed description of various legal forms we recommend Sa-dhan's 'Existing Legal and Regulatory Framework for the MFIs in India: Challenges and Implication'
- 2 Manual on Financial and Banking Statistics, Box 6.2, Chapter VI, Reserve Bank of India, <http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/78928.pdf>
- 3 While banking is an exclusive subject in the domain of the Parliament by virtue of Entry 45 of List I of the VIIth Schedule, Entry 30 of List II authorises the State Legislature to enact on "money-lending, money-lenders, and relief of agricultural indebtedness".
- 4 Net assets are the total assets other than cash and bank balances and money market instruments.
- 5 Qualifying assets refer to the loans which satisfy the following criteria: (i) loans disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs. 60,000 or urban and semi-urban household income not exceeding Rs 1,20,000.
- 6 Master Circular- Introduction of New Category of NBFCs – 'Non Banking Financial Company – Micro Finance Institutions' (NBFC-MFIs)-Directions, Dated July 2, 2012, DNBS.(PD)CC.No.293/03.10.38/2012-13, available online at [http://www.rbi.org.in/scripts/BS\\_ViewMasCirculardetails.aspx?id=7392](http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=7392).
- 7 Non-Banking Financial Company – Micro Finance Institutions (Reserve Bank) Directions, 2011
- 8 Brix, L. and McKee, K. (2010). *Consumer Protection Regulation in Low-Access Environments: Opportunities to Promote Responsible Finance*, CGAP Focus Note 60. Washington, DC: CGAP, February