Emerging Scenarios for Microfinance Regulation in India

Some Observations from the Field
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# List of Abbreviations and Acronyms

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<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>AIAMED</td>
<td>All India Association for Micro Enterprise Development</td>
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<td>APMACS Act</td>
<td>Andhra Pradesh Mutually Aided Cooperative Societies Act</td>
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<td>APMAS</td>
<td>Mahila Abhivrddhi Society, Andhra Pradesh</td>
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<td>ASA</td>
<td>Association for Social Advancement</td>
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<tr>
<td>BASIX</td>
<td>Bharatiya Samruddhi Investments &amp; Consulting Services</td>
</tr>
<tr>
<td>CASHPOR</td>
<td>Credit and Savings for the Hardcore Poor</td>
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<tr>
<td>CGAP</td>
<td>Consultative Group to Assist the Poor</td>
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<tr>
<td>DCCB</td>
<td>District Central Cooperative Bank</td>
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<tr>
<td>DFID</td>
<td>Department for International Development</td>
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<td>FN</td>
<td>Footnote</td>
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<tr>
<td>GoI</td>
<td>Government of India</td>
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<td>GTZ</td>
<td>Deutsche Gesellschaft für Technische Zusammenarbeit (German Technical Cooperation)</td>
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<tr>
<td>INAFI</td>
<td>International Network of Alternative Financial Institutions</td>
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<td>IRDP</td>
<td>Integrated Rural Development Programme</td>
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<tr>
<td>LAB</td>
<td>Local Area Bank</td>
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<tr>
<td>MFI</td>
<td>Microfinance Institution</td>
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<tr>
<td>NABARD</td>
<td>National Bank for Agriculture and Rural Development</td>
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<tr>
<td>NBFC</td>
<td>Non-Banking Financial Company</td>
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<tr>
<td>NGO</td>
<td>Non-government organisation</td>
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<tr>
<td>NPA</td>
<td>Non-performing asset</td>
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<td>PACS</td>
<td>Primary Agricultural Cooperative Societies</td>
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<td>R</td>
<td>Indian Rupee; exchange rate used: 1 US$ = 45 Rs</td>
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<tr>
<td>RBI</td>
<td>Reserve Bank of India</td>
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<tr>
<td>RNBC</td>
<td>Residuary Non-Banking Company</td>
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<tr>
<td>RPCD</td>
<td>Rural Planning and Credit Department</td>
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<tr>
<td>RRB</td>
<td>Regional Rural Bank</td>
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<tr>
<td>SFMC</td>
<td>SIDBI Foundation for Micro Credit</td>
</tr>
<tr>
<td>SGSY</td>
<td>Swarnajayanthi Gram Swarozgar Yojana</td>
</tr>
<tr>
<td>SHARE</td>
<td>Society for Helping, Awakening Rural Poor through Education</td>
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<td>SHG</td>
<td>Self-Help Group</td>
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<td>SHPI</td>
<td>Self Help Promoting Institutions</td>
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<td>SIDBI</td>
<td>Small Industrial Development Bank of India</td>
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<tr>
<td>SIFCL</td>
<td>Sahara India Financial Corporation Ltd</td>
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<td>SRO</td>
<td>Self-Regulatory Organisation</td>
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Executive Summary

There is an ongoing debate in India as to whether the current legal environment for the financial sector accommodates the specific characteristics of microfinance and, if not, what kind of legal amendments or revisions are needed. The outcome of this debate is still open. If the reader expects a clear answer to the many questions surrounding this debate, he or she might be disappointed. If they want to be provided with an overview of issues and arguments with regard to the various aspects of the debate, we hope that this paper will serve as a helpful point of reference.

The expected audience of this paper consists of two groups. Firstly, it can act as a reference point for all those involved with shaping the future development of the legal framework for microfinance in India. Secondly, the paper is directed at an international audience that would like to inform themselves about the current state of the debate on this topic.

The document captures the current debate (as of October 2003) about microfinance regulation in India as expressed by leading microfinance experts in the country. The authors held a number of discussions with around 40 high-ranking experts in the industry. The outcome is a snapshot of views enriched by reference to international experience wherever this seemed appropriate.

To structure the discussion, the authors developed three broad scenarios, which logically follow from each other. All three scenarios have their unique pros and cons. This approach clearly spells out the strengths and weaknesses of each case. It is up to the reader which one they find most promising. They are as follows:

**Scenario 1**, called ‘Focus on Formal Banking Infrastructure’, assumes that the recent growth of the Self-help group (SHG)-bank linkage model and its ready acceptance and success in terms of outreach, viability, and positive impact on the livelihoods of the poor advocates a focus on the formal banking sector as a provider of microfinance. As this sector to date is already under prudential regulation by the central bank, proponents of this scenario do not see a need for major regulatory changes or adjustments. An important – and hotly debated – corollary is that linkages with SHGs and similar microfinance services provided by the formal sector should be a profitable business niche for the respective supplier as otherwise it would not be sustainable in the long run. Only then can it be rightly claimed that the existing formal banking sector should be the main provider of microfinance services in India.

**Scenarios 2 and 3** are more sceptical about the potential role of the regulated banking sector in the future. They follow the lines of arguments in many other countries where the role of the banking sector is negligible, even though they acknowledge the success of the SHG-bank linkage model. Both scenarios start from the proposition that the SHG-bank linkage model alone cannot satisfy the huge demand for microfinance in India.
Under the heading ‘Amend Existing Legislation for MFIs’, **Scenario 2** looks at the current legal environment for microfinance institutions (MFIs) such as Non-Banking Financial Companies (NBFCs), microfinance NGOs and federations of SHGs. For each type of MFI, challenges and constraints under the existing laws are listed and possible remedies pointed out.

**Scenario 3** is similar to scenario 2, only that according to this scenario it is more promising to introduce a new special law for microfinance than to follow the piecemeal approach of making a number of smaller changes in various laws that effect MFIs.

The final chapter goes beyond the discussion held with microfinance experts in India. By looking at relevant experience in other countries, it tries to reflect upon the debate in India against the backdrop of the international discussion about microfinance regulation.
1. Background to the Study

India seems to be a very peculiar case when it comes to microfinance regulation and supervision. It is not only its sheer size that makes it very different from all others countries. The involvement of formal public sector banks is also much stronger than anywhere else. This means that a relatively (and increasingly) large share of the microfinance sector is under the purview of the central bank, the Reserve Bank of India (RBI). When the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) commissioned a comparative study on legal frameworks for microfinance, it was decided that India does not easily fit into the format chosen for this study, and that it would be worth studying the case in more depth.¹

Other than the comparative study, which was a desk study and therefore focused on an analysis of existing laws and regulations for microfinance, this study involved two weeks of extensive travelling by the consultants. The study team, consisting of an international and a local consultant, held wide-ranging discussions with practitioners in different states of the country about regulatory arrangements and requirements for microfinance. They talked to senior officials of Government of India (GoI), RBI, the National Bank for Agriculture and Rural Development (NABARD), commercial banks, Regional Rural Banks (RRBs), Mutually Aided Cooperative Societies (MACS), NGOs, Non-Banking Financial Companies (NBFCs), Self-Help Groups (SHGs) and SHG federations.²

The main thrust of this study is not to analyse the current legal framework, but to capture the current debate on and possible future steps for microfinance regulation. The reason is that there are a number of studies available on legal issues of microfinance in India and on recommended amendments to the existing legal framework in order to render it more ‘microfinance-friendly’. Yet on the implementation side, progress is rather slow. This study aims to provide the reader with a snapshot of views of key stakeholders in the debate. It neither gives a general overview of the microfinance sector in India, nor does it repeat everything that has been said in previous studies about microfinance regulation in India.³

The authors would like to express their gratitude to all those who have contributed during the course of this study. This paper would not have been possible without their openness and cooperation.

The study starts with some remarks on the terminology used throughout this text. Chapter 3 recalls recent initiatives and legal amendments in the field of microfinance regulation. The main body of the text outlines three different scenarios that reflect key issues having been raised during our discussions. All of the scenarios have their unique pros and cons. The objective of this study is to spell out strengths and weaknesses of these scenarios, and the status of and possible need for revising regulations under each scenario. It is the authors’ belief that the decision about the way forward can only be taken through a

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¹ The comparative study has been published as Staschen (2003b).
² For a complete list of persons consulted, please refer to Annex 1.
³ A number of studies are available, which look into the appropriateness of current legislation. Key documents are the following: NABARD (1999); Sinha (2000); Fukaya and Shadagopan (2001); Sa-Dhan (2002a); Sheshadri (2002). In addition, the World Bank (2001) and IFAD (2003) have recently undertaken reviews of the microfinance sector. However, both reports are confidential.
1. Background to the Study

consultative process of consensus finding among all stakeholder groups concerned. The scenarios are as follows:

- According to scenario 1, a focus on the existing formal banking infrastructure along the lines of the SHG-bank linkage model may be the best way to go. There is hardly any need for regulatory change or adjustment. If one accepts this scenario as the best way forward, scenarios 2 and 3 become superfluous;
- Scenario 2 delineates the existing role of the MFI sector. It starts from the proposition that the SHG-bank linkage model alone cannot satisfy the demand for microfinance in India. The scenario looks at current constraints for different types of MFIs and lists possible regulatory changes, which may create a more level playing field;
- Finally, scenario 3 is similar to scenario 2 in that it acknowledges a role for the microfinance sector alongside linkage banking. It analyses the effects of establishing a separate legal framework for microfinance, which is favoured by some experts in order to streamline the sector.

The last chapter gives some concluding remarks against the background of experiences with microfinance regulation in other countries.
2. Some Remarks on Terminology

A stringent categorisation of financial institutions involved in microfinance is not easy. To avoid confusion, the following categorisation is used throughout this study.4

- Banks comprising commercial banks (both public and private), Regional Rural Banks (RRBs), cooperative banks and Local Area Banks (LABs);
- Deposit-taking Non-Banking Financial Companies (NBFCs);
- NBFCs registered as Section 25 companies;
- Microfinance NGOs; and
- Federations of SHGs, usually in the form of cooperatives such as Mutually Aided Cooperative Societies (MACS).

The last four categories are often generically referred to as MFIs, while banks serving the microfinance sector are also called microfinance service providers.

Banks are regulated and supervised by the RBI. They are governed by the RBI Act, Banking Regulation Act, Regional Rural Banks Act (for RRBs) and the Cooperative Societies Acts of the respective state governments (cooperative banks). For RRBs and District Central Cooperative Banks (DCCB), the supervisory tasks have been delegated to NABARD.

Banks' involvement in microfinance is almost exclusively through linkages with SHGs. These linkages are either direct linkages between banks and SHGs or indirect linkages via MFIs.

NBFCs are registered under the Companies Act, 1956. They are also required to be registered with the RBI under the RBI Act, 1934, and must comply with directions issued by the RBI.5 Section 25 companies are not-for-profit NBFCs registered under Section 25 of the Companies Act. Under certain conditions, they are exempted from a number of legal requirements under the RBI Act (cf. Ch. 3.3).

There is no specific law catering to NGOs. Microfinance NGOs can be registered under the Societies Registration Act, 1860, the Indian Trust Act, 1882, or the relevant State Acts. The grassroots level formations or groups (Self Help Groups or Credit and Savings Groups), through which other financial institutions are channelling their financial services, are informal and unregistered. The main funding sources for NGOs are donors, government departments and to a small extent bank credit as well as the savings of the poor. The SHG-Bank Linkage Programme opened up the banking system as an additional source of funds.

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4 For a slightly different categorisation, see NABARD (1999: Ch. 2); Fukaya and Shadagopan (2001: 23ff.).
5 RBI Notification No. DFC.114/DG(SPT)-98 dated January 2, 1998. Please note that the cooperative sector is largely left out in this study, as regulatory issues in the sector are very specific and would thus justify a study on its own. This sector comprises about 92,000 Primary Agricultural Cooperative Societies (PACS) alone that are not effectively regulated.
2. Some Remarks on Terminology

The cooperative sector is only touched upon briefly in this paper. Of interest for this study is the relatively recent institutional form of Mutually Aided Cooperative Societies (MACS), which as of yet only exists in 8 Indian states (cf. Annex 3).

In India, the term *financial intermediation* is used differently than in many other countries. While in most documents on microfinance regulation financial intermediation is understood as the mobilisation of deposits from the public and onlending of these funds, in India institutions borrowing funds from wholesale lenders and giving them out as loans are also regarded as engaging in financial intermediation.

Finally, while in many countries the main line is drawn between deposit mobilisation from members (i.e. shareholders of cooperatives) and from the public (the latter requiring stronger external oversight), some microfinance experts in India make the main distinction between deposits from the general public and from clients, which are at the same time borrowers of the institution (cf., for example, NABARD 1999: Ch. 3.8).
3. Recent Initiatives in the Field of Microfinance Regulation

A number of recent initiatives have dealt with the issue of microfinance regulation. This can be taken as a sign of growing interest in the field. Below, some of the most important initiatives are briefly summarised. Furthermore, some of the regulatory changes triggered by this debate are listed.

3.1 The NABARD Task Force

In the late 1990s, it was felt that a suitable national policy framework was essential for the orderly development of the microfinance sector in the country. Various critical issues such as ways to scale up microfinance programmes in India, the division of roles between existing mainstream financial institutions, development banks and newly emerging microfinance institutions (MFIs) and the need for an appropriate policy and regulatory framework for their operations were engaging the attention of microfinance practitioners, the Government and the RBI. It was at this juncture that in November 1998 a high-powered Task Force on Supportive Policy and Regulatory Framework for Microfinance (henceforth referred to as the Task Force) was set up by NABARD at the instance of RBI. The Task Force comprised senior officials from GoI, RBI, NABARD, banks and chief executives of prominent NGOs implementing various microfinance models in the country. The objectives of the Task Force were, among others, to come up with suggestions for a regulatory framework that brings the operations of the MFIs into the mainstream, to assess the possible role of self-regulatory organisations and to explore the need for a separate legal framework for microfinance. To date, this has been the most comprehensive study about legal issues for microfinance.

The Task Force (1999) made various recommendations, based on which RBI issued a number of important instructions to microfinance practitioners (cf. chapter 3.3). For the first time, a definition of microfinance was agreed upon. The definition is broad enough to allow for different types of institutions offering various types of financial services.\(^6\)

With regard to the hitherto unregulated microfinance NGO sector, setting up a system of self-regulatory organisations (SROs) features prominently among the recommendations. The Task Force recommends a classification of MFIs according to the question of whether deposit facilities are offered or not and if so, what kind of facilities these are. Both the amount of savings mobilised (below or above a pre-determined cut-off limit) and the origin of savings (from clients or from the general public) determine the extent of external control by a supervisory authority.

The strong reliance on self-regulation even for NGOs mobilising deposits from the public does not go in line with more recent recommendations from other international experts, who stress the enforcement problems of a self-regulatory framework and the potential

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\(^6\) Microfinance is defined as: “Provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and improve living standards”. Mahajan and Ramola have criticised, among others, that “very small amount” has only been defined for credit (and only unsatisfactorily); cf. Mahajan and Ramola (2003: 4f.)
3. Recent Initiatives in the Field of Microfinance Regulation

conflicts of interest of the SROs.\(^7\) Basing the extent of regulation on the origin of savings is similar to van Greuning’s (et al.) approach of looking at the liability side of the balance sheet to determine the need for external regulation (van Greuning, Gallardo, and Randhawa 1999).

### 3.2 Other Working Groups on Regulatory Issues

Following a meeting at the Prime Minister’s Office in October 2001, seven working groups comprising government, NGOs and banking sector representatives were set up, one of them with the mandate of exploring the legal and regulatory challenges currently faced by the microfinance sector in India. In December 2002, the reports of six of the seven working groups were finalised. The Indian microfinance association Sa-Dhan – as one of the members of the group looking into regulatory issues – prepared a report summarising the group’s results (Sa-Dhan 2002a). This report gives clear recommendations regarding how to make the current legal framework more microfinance-friendly. Some of these need immediate attention; some are for the longer term. In addition, the document indicates a way forward for the debate with a strong emphasis on gathering information about the sector as a precondition for better regulation.

RBI has continuously watched the progress of microfinance. In October 2002, the RBI constituted four informal groups for addressing various aspects of microfinance including regulatory arrangements and funding issues. Senior bankers, NGOs and prominent microfinance practitioners and all stakeholders are represented in these informal groups. The recommendations of these informal groups have recently been made public. They are of great importance as some of the changes favoured by a number of stakeholders require the attention and involvement of the RBI.

Major recommendations of these informal working groups are to create a separate category of non-deposit taking NBFCs with a lower capital requirement of Rs. 2.5 million (US$ 56,000), and to require NGOs and federations of SHGs either to wind up their savings business and transform into Section 25 companies or to transform into NBFCs or MACS.

### 3.3 Recent Regulatory Amendments for Microfinance

Due to the increased attention to regulatory issues for microfinance, several legal and regulatory changes were initiated over the recent years. The most important changes are a number of instructions issued by the RBI, which for the first time specifically deal with microfinance.\(^8\)

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\(^7\) Cf., for example, CGAP’s Guiding Principles on Regulation and Supervision of Microfinance, which conclude: “Self-regulation of financial intermediaries in developing countries has been tried many times, and has virtually never been effective in protecting the soundness of the regulated organizations.” Christen, Lyman and Rosenberg (2003).

\(^8\) It is important to note that the Reserve Bank of India often issues very comprehensive notifications in circular letters giving detailed instructions, explaining its policy or stipulating regulations. To give an example, between 1998 and today the RBI has published 35 notifications regarding NBFCs alone.
3. Recent Initiatives in the Field of Microfinance Regulation

Mainstreaming of SHG-Bank Linkage Model

A Working Group on NGOs and SHGs set up by RBI in 1995 looked into various aspects of the linkage between informal SHGs and banks. According to the model, formal banks lend either directly or through an intermediary such as an NGO or an SHG federation to groups of poor people, mostly women. Based on the recommendations of the Working Group, RBI in 1996 issued instructions to the banks to treat the SHG-bank linkage model as part of their mainstream lending.\(^9\) According to the circular, lending to SHGs or to NGOs for onlending to SHGs is taken as part of their directed lending.\(^10\) Furthermore, SHGs are allowed to open savings accounts with banks. The operational guidelines, earlier issued by NABARD in 1992 for lending to SHGs, envisaged complete flexibility for the banks in regard to lending norms like interest margin, amount to be lent, use of collateral security, repayment period etc.\(^11\) These guidelines are well accepted by the banking system for providing financial services to the poor. Over the years, the linkage programme has made very good progress.

In April 1999, RBI set up a 'Micro Credit Special Cell'. This demonstrates RBI's increased interest in the microfinance sector.

Exemptions for Non Deposit-Taking Section 25 Companies

As regards Non-Banking Financial Companies, the RBI issued instructions on 13\(^{th}\) January 2000 to the effect that if NBFCs are engaged in 'micro-financing activities', registered under Section 25 of the Companies Act, 1956, and not accepting public deposits, they would be exempt from the purview of Section 45-IA (registration and minimum net owned funds), 45-IB (maintenance of liquid assets) and 45-IC (transfer of profits to reserve fund) of the RBI Act, 1934.\(^12\) These instructions essentially created a new legal form for providing microfinance services without having to comply with the strict regulatory requirements for NBFCs. Section 25 companies are not subject to any capital or liquidity requirements. According to Section 25 of the Companies Act, they must use potential profits for promoting its objects.\(^13\) Although they are not explicitly exempted from supervision by the RBI, in practice they only report to the Registrar of Companies. The price for this is that they are not permitted to go into deposit-taking business.

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\(^10\) 40% of net bank credit must be lent to the priority sector, of which 25% are to be lent to the 'weaker section'.


\(^13\) Sec 25 (1) lists describes such a company as an association “formed as a limited company for promoting commerce, art, science, religion, charity or any other useful object”. It is at least questionable whether microfinance falls under any of these activities.
3. Recent Initiatives in the Field of Microfinance Regulation

Allowing More Flexibility for Banks Offering Microfinance Services

In a circular letter to the banks dated 18th February 2000, RBI recognized the definition of microfinance as proposed by the Task Force. The central bank advised that for mainstreaming microfinance and to enhance the outreach of microfinance service providers, banks are free to choose their own model for extending microcredit. Further, microcredit extended by banks to individual borrowers directly or through any intermediary would be taken as part of their priority sector lending. Banks are expected to make microcredit an integral element of their corporate credit plans, which are to be monitored by the central bank. To increase microlending, the RBI recommended simplification of loan documentation and decentralisation of the loan decision by delegating more power to branch managers. Other than for small loans given directly by banks to small borrowers, the interest rate for loans to MFIs and for MFIs lending to the ultimate borrower were fully liberalised.

A Self-Regulatory System for MFIs Has Not Found Sufficient Support

There were some initiatives from the microfinance sector to build a consensus among the industry and to advocate for putting in place a broad-based system for regulation of the microfinance sector and, more particularly, the MFIs in the country. The prospect of instituting a self-regulatory regime as proposed by the Task Force was discussed very actively. Yet as of now, the RBI has not delegated any regulatory power to a self-regulatory organisation. Despite their initial enthusiasm and the recommendations of the Task Force, the MFIs have recently lost interest in establishing SROs. In the recommendations of the informal group set up by RBI, SROs do not figure at all.

Against this background, the following chapters develop different scenarios that have taken shape during the discussions with different stakeholders in the industry. Keeping in view the broad objective of providing financial services to the hitherto unserved rural poor in the shortest possible time, the different scenarios bring out the prospect of achieving this objective in different ways. The focus is on the prevailing status of regulation in each scenario and the need and scope for change thereunder.

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14 RBI Circular RPCD.No.PL.BC. 62/04.09.01/99-2000 dated February 18, 2000. Following the terminology of the Microcredit Summit Campaign, the RBI uses the term microcredit, although it explicitly includes ‘thrift’ (i.e. reduced/deferred expenditure) and other financial services.

15 RBI Circular RPCD.No.PL.BC 94/04.01.01/98-99 dated April 24, 1999. Reportedly, some banks are still stipulating a 3 percent maximum spread for onlending by NGOs.

16 At this time, Sa-Dhan published a book on microfinance regulation in India, which very clearly advocates for a self-regulatory approach as earlier recommended by the Task Force; cf. Fukaya and Shadagopan (2001).
4. **Possible Ways Forward**

The GTZ study team held wide-ranging discussions with practitioners in different states of the country. The discussions centred around the following topics: the state of implementation of the Task Force recommendations and the significance of its proposals that are yet to be put into practice; recent steps taken to improve the legal framework for microfinance; and remaining shortcomings and weaknesses of the available legal frameworks for microfinance. It was seen as important not only to look at the technical side of an appropriate legal framework for various types of MFIs and microfinance service providers, but also at the feasibility of initiating potential changes.

What became clear from the discussions was that the main interest is not to commission yet another study on regulatory issues for microfinance, but to point out possible ways where one can go from here.

This chapter summarises the main arguments brought forward in the discussions with stakeholders from the industry. To structure the arguments, three different ‘scenarios’ are presented. Starting from the prevailing state, each scenario describes a general approach of how to proceed from here in order to further enlarge the microfinance sector in the country.

4.1 **Scenario 1: Focus on Formal Banking Infrastructure**

Since the banking sector is very well scattered in the country and India has a long tradition of ‘banking with the poor’ through various government-sponsored programmes or directed lending quotas which specifically target the poor, focussing on the formal banking system seems an obvious choice for a possible scenario. Scenario 1 assumes that the recent growth of the SHG-bank linkage model and its ready acceptance and success in terms of outreach, viability, and positive impact on the livelihoods of the poor advocates a focus on the formal banking sector as provider of microfinance. The success of the SHG-linkage banking model reduces the need for other microfinance service providers such as NGOs.

The reader might be surprised to find a discussion on the profitability of linkage banking as part of this chapter, as this is not directly a regulatory issue. This discussion has been included as the whole question as to whether India needs something else besides the SHG-linkage banking model on the profitability and thus long-term sustainability of this model.

This chapter looks at the following issues:

- Evidence of the success of the SHG-bank linkage model;
- Regulatory issues with regard to SHGs and RRBs; and
- Potential risks of the SHG-bank linkage model in the future.
Success of the SHG-Bank Linkage Model

Over recent years, the SHG-Bank Linkage Programme has experienced unprecedented growth rates. As of 31 March 2003, more than 717,000 SHGs have been linked with banks with a total credit of US$ 455 million.\(^\text{17}\) During 2002-03 alone, banks extended credit to 256,000 SHGs amounting to US$ 227 million. The number of branches of banks lending to SHGs has gone up to 30,942. The SHG-bank linkage model benefited cumulatively more than 11 million rural families (including repeat finance). Overall 504 banks (48 commercial banks, 192 RRBs and 264 DCCBs) participated in the linkage programme supported by more than 2800 NGOs and other agencies. Thus, the SHG-bank linkage model evolved as the fastest growing microfinance programme in the world. Annex 2 gives some more information on the development of linkages with SHGs.

The SHG-bank linkage model uses the available financial infrastructure for providing financial services to the poor. Loans issued are small, without any collateral security, and with an average size of Rs. 1,766 or US$ 39 per family. Most of the customers did not get a sustained service from the banking system earlier. The model has the twin advantages of reducing the transaction costs for banks, while ensuring very good repayment performance. The repayment rate (percentage of loans repaid on time) is 95 per cent and higher. None of the participating banks has reported any NPAs under the SHG-bank linkage model.\(^\text{18}\) These impressive results have prompted RBI to adopt special measures for the promotion of SHG bank linkages. The central bank governor has called upon the banks to provide adequate incentives for the branches to promote the linkage programme.

On the savings side, pooled savings from SHGs are growing. The deposits are reported to have become an attractive source of funds for some, particularly RRB branches. According to the central bank, in March 2003 banks held US$ 100m in savings accounts from SHGs. The amount of savings circulating within the SHGs is estimated to be even higher.

Taking into account the presently limited outreach and sustainability of the microfinance sector, a number of respondents had the view that the best strategy is to use the existing infrastructure of the public and private banking sector to reach more people on a sustainable basis.

From a regulatory point of view this means that only minor amendments are needed. With 95 commercial banks, 369 DCCBs, 196 RRBs and 4 LABs and an overall number of branches of 66,692 (figures as of June 2003), India has probably the highest branch density in the developing world. On average, there is one branch for 16,000 people. Further, there is good prospect of involving a large number of Primary Agricultural Credit Societies (PACS) under the linkage model as has been demonstrated by a number of DCCBs, which have adopted linkages to SHGs as a model for enhancing their business.\(^\text{19}\)

\(^{17}\) These are cumulative figures. As of 31 March 2004, 1.08 million SHGs have been financed by banks.

\(^{18}\) Currently, assets are classified as non-performing if interest or instalment payments remain unpaid for six months and more. In 2004, more stringent norms will be introduced for RRBs and for Cooperatives (both 90 days).

\(^{19}\) If we add about 92000 PACS, the figure comes to about 5000 people per rural credit delivery outlet.
4. Possible Ways Forward

All these branches (yet not the PACS) report to the central bank. Furthermore, even to date all banks as the major stakeholders in the linkage model are part of the system of prudential regulation by the central bank. Commercial banks are subject to prudential regulations in line with international standards, while RRBs and cooperative banks comply with all these standards except a capital adequacy ratio. In a way this implies that the microfinance sector in the country is, to a large extent, already regulated. Thus many people rightly argue that the share of microfinance services provided by prudentially regulated institutions is extremely high.\(^{20}\)

**Regulatory Issues with the SHG-Bank Linkage Model**

As already said, the SHG-bank linkage model makes use of the existing, prudentially regulated banking sector. Only minor regulatory issues were mentioned with regard to SHGs. As regards SHGs, they are conceived as informal under the linkage-banking model. As SHGs are not required to be incorporated under any Act, their operations are flexible and can remain simple. Their informal character is seen as one of the strengths of SHGs. The group can, through a simple power of attorney, bind the members both jointly and severally as regards dues to outside institutions, and thus it appears fairly clear that a creditor can proceed against any individual member of the group to recover its dues. From a regulatory perspective, the informality of the groups, their limited size of maximum twenty members, and their collective decision making guarantee strong internal control and low systemic risk. External regulation therefore seems neither practicable nor necessary.

This view is widely shared among practitioners in the microfinance sector. The RBI made it very clear in its credit policy of November 3, 2003, that the group dynamics of SHGs may be left to themselves and that SHGs need neither be regulated nor formal structures imposed upon them.\(^{21}\) Further, the procedures for bank linkage should be simple and easy, suited to local conditions.

Some people, however, have taken the position that the absence of any legal endorsement of SHGs under any Act may question their legality. It is feared that the lack of an appropriate legal status of SHGs may, in future, hamper the recovery of overdues. One suggestion, therefore, was that SHGs could be appropriately referred to under any of the Acts and their non-incorporation may be duly recognised to avoid any legal difficulty in the future.

\(^{20}\) Cf. the opposite view of Sinha (2000: 70): “The present level of regulation of microfinance in India is negligible.” Which view to take depends on whether one sees SHGs as financial institutions or simply as a kind of lending technology used by banks and MFIs.

\(^{21}\) Cf. the following extract from the statement of the Governor of the RBI on the Mid-Term Review of Monetary and Credit Policy for the year 2003-04, made on November 3, 2003: “RBI constituted four informal groups to examine various issues concerning micro-finance delivery. On the basis of the recommendations of the groups, it is proposed that: (i) banks should provide adequate incentives to their branches in financing the Self Help Groups (SHGs) and establish linkages with them making the procedures absolutely simple and easy while providing for total flexibility in such procedures to suit local conditions; (ii) the group dynamics of working of the SHGs may be left to themselves and need neither be regulated nor formal structures imposed or insisted upon; (iii) the approach to micro-financing of SHGs should be hassle-free and may include consumption expenditures to enable smoothing of consumptions as needed relative to time-profile of income flows.”
Some interview partners were concerned about a possible major handicap of informal and unincorporated SHGs in regard to the mobilisation of deposits. In their view, a critical issue is the legal definition of deposits as stated in Section 45S, RBI Act. According to this Section of the Act, unincorporated bodies are prohibited from accepting deposits from the public. However, this issue has been dealt with by the stated policy of the RBI and, lately, through the Governor’s policy statement (cf. FN 21). The savings circulating within the SHGs are to be regarded as quasi capital, with both ownership and management of savings with SHGs. In approving the regulatory guidelines issued by NABARD in November 1992 (see FN 11), it has been recognized by the RBI that the provisions of Section 45S are by implication not applicable to SHGs, and that SHGs’ savings operation are the indispensable starting point for linkages with banks.

An issue mentioned was the interest rate cap for loans below Rs. 200,000, which may not exceed the prime lending rate. According to some experts, this rate is too low to allow for profitable lending to SHGs. Others talked of a “social cap on interest rates” meaning that even if interest rates were fully liberalised, there would still be social pressure not to raise the rates above a certain limit.

**The Profitability of SHG-Bank Linkages**

The question of whether linkages with SHGs are a profitable business for banks turned out to be one of the most hotly debated issues. From a regulatory point it is seen as important as banks will only be interested in lending to SHGs in the long run if they can make a profit with it. Those people questioning the profitability of linkage banking presented some or all of the following arguments:

- The reason for the low (and still declining) interest rates is not that lending to SHGs is so cheap, but rather that the political and social pressure to serve poor people with cheap loans is high;[23]
- There are other motives for bankers to do linkage banking than the profit motive. Particularly commercial banks find it at times difficult to comply with priority sector lending requirements. RBI is putting pressure on these banks. Reportedly, in one case the central bank refused to licence new branches unless the bank met the prescribed quotas. Linkage banking could be seen as a potential way to increase priority sector lending, even though its share in total lending of commercial banks is still very small. Furthermore, in some instances there is pressure from the political side to increase lending to SHGs.
- Another argument went that it would not be necessary for NABARD to provide subsidised refinance in respect of linkage banking loans if it was a profitable business for banks.[24]

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22 It should be mentioned that this is the only interest rate restriction left, while in former times both lending and savings rate were usually fixed by the central bank.

23 During the discussions, one of the senior bankers said about the pricing of linkage banking loans: “We thought that these women deserve some concessionary rate of interest”.

24 This argument is certainly no proof that linkage banking is not profitable, but only questions the current practice that NABARD offers subsidised refinance for banks’ lending to SHGs. In fact, refinance by NABARD is not considered cheap any longer, as market rates have come down considerably. Most of the
4. Possible Ways Forward

- It was asserted by others that banks represent the most costly source of funds for the customers, even though interest rates might be lowest. What makes them costly are transaction costs such as travel costs to the next branch office, and the opportunity costs of the time spent on branch visits.

Also, a number of counter-arguments have been stated:

- The transaction costs for customers are considerably reduced over time as bank branches issue repeat loans much more quickly.
- As of 31st March 2003, the share of groups linked with banks, which had been directly promoted by banks, had increased to 20%. The remaining 80% were groups promoted by NGOs, government agencies, etc. The number of groups formed by the banks has been steadily increasing over recent years. For example, it was only 16% one year earlier. This reflects an increased interest of banks in promoting and nurturing SHGs of their own accord. In addition, more and more women actually promote their own groups.
- It is reported that one commercial bank has decided to reimburse the promoter of SHGs the costs of promotion for every group linked with it. This can be seen as a sign that banks are increasingly seeing linkage banking as a profitable business.
- Many banks are voluntarily contributing from their profits to the Microfinance Development Fund maintained with NABARD. This fund disburses grants to NGOs promoting the linkage model. As of 31st March 2003, more that 600 NGOs have benefited from these grants. The promotional costs can be seen as institution building and customer development costs, which must not be borne by the banks themselves.
- The degree of the banks’ preference for the SHG-bank linkage model can be gauged from the fact that banks are taking measures like conducting tailor-made programmes for their staff, promoting groups on their own, etc, to enhance their SHG portfolio.

A number of discussions centred on the question of how to choose an adequate methodology for measuring the profitability of linkage banking:

- The first question is where to draw the line between institution-building costs, which must not be borne by the banks themselves, and the costs of client education, which should be part of the operational costs of banks.
- It was stated that the opportunity costs for banks’ staff spending more time on linkage banking are low as many banks have idle capacity. Thus some people reasoned that it makes more sense to look at opportunity costs than absolute costs.

25 In 1998, NABARD framed a corporate plan to facilitate linkage of one million SHGs in 10 years, i.e. by 2008. But due to the enthusiastic participation of the banks, the landmark appears achievable much ahead of the deadline, possibly by March 2004.

26 Yet some banks mentioned that the large number of SHG members visiting the branches has made it difficult for branch staff to attend to other customers in the accustomed manner. Thus some banks have earmarked certain days of the week for exclusively serving group members.
4. Possible Ways Forward

- It was reported that SHGs recover arrears from previous bank customers, who are now pressurised to pay back their outstanding loans. Furthermore, successful customers from SHGs might become individual customers in the future.
- Some respondents stated that enforcement costs come down over time as other SHGs in the same village might assist in strengthening the repayment discipline.

The question of the profitability of SHG lending has not been definitively answered. A number of studies have come to different results. A study conducted by M-CRIL in 5 RRBs across the country, estimates that the cost-covering rate of interest for linkage banking for RRBs lies in the region of 20% to 22% (Sinha et al. 2003). But another comprehensive study by Hans Dieter Seibel establishes that banks are making a profit with their SHG portfolio, notwithstanding the lower rates of interest charged by some banks, mainly due to the non-occurrence of NPAs (Seibel and Harishkumar 2002). It would be helpful to continue the discussion on the best methodology to assess the profitability and the optimum rate of interest. A study including a larger sample of banks could shed more light on this.

From a regulatory point of view, the main point of interest is not the profitability of the linkage banking model, but whether this is the best model to meet the huge demand of poor people for financial services while simultaneously protecting the interest of small savers. In the long run, profitability issues will certainly have a bearing on this.

Potential Issues with the SHG-Bank Linkage Model

The strong growth of the linkage-banking model is a relatively recent phenomenon. Some people argue that the current impressive results cannot simply be extrapolated into the future.

The following were mentioned as potential risks:

- Some interviewees expressed reservations about the quality of new groups promoted in certain states. It is feared that the rapid growth in the linkage programme may hamper the quality of the groups as all high quality groups have already been linked to banks. Essential group processes like the holding of regular meetings, continuous saving by group members and the exertion of group discipline might suffer.
- Some experts saw the present macroeconomic environment as being exceptional. According to this view, the interest rates are the lowest in years, which makes other investment opportunities less attractive. Most banks have excess liquidity and access capacity, so that even a relatively labour-intensive lending methodology with a low return becomes attractive.

27 Furthermore, Seibel assumed that bankers are subject to zero opportunity costs as many of them are underemployed.
28 For this debate see also Sinha and Bakshi (2004).
Some other reservations have been expressed with regard to the future potential of the SHG-bank linkage model:

- A number of experts expressed doubts as to whether direct linkages with SHGs can ever attract the interest of commercial banks for prolonged periods. In their view, it is more likely that most of the commercial banks may henceforth rely on indirect linkages via NGOs or SHG federations. Thus in the future it will be much more important to look at regulatory problems on this level.\(^{29}\)

- Some regard the SHG-bank linkage model as inherently constrained. While they acknowledge its success in reaching previously unserved customers, they point out that the form of a SHG quickly becomes constraining. Diversification of risks on this level is rather limited. The potential for growth is restricted as the groups are not allowed to grow beyond 20 members. Individual loan amounts are rather small. New products such as bank cards, health and sanitation finance, and contractual savings for old-age etc. may not be easy to introduce in SHGs. Again, SHG federations (a growing number of whom is registered as MACS) and NGOs will gain in importance. The corollary is that in the future more attention should be drawn to the appropriateness of regulation on this institutional level (cf. chapter 4.2).\(^{30}\)

- There are different estimates of the costs of promotion of SHGs. They are in the range of Rs, 1,500 (NABARD) up to Rs. 10,000 and more (Dhan Foundation) depending upon the philosophy of the promoter (US$ 30 to 140). Creating a comparable number of SHGs in all states of the country would require substantial resources or a strong increase in self-promoted SHGs.

- Even though the linkage model has spread rapidly in many states, it is yet to fully cover the poor in all states of the country. Currently, the model is geographically concentrated in the South and West of India. There are various reasons for the slow growth in other regions, such as unsatisfactory law and order and difficult socio-economic conditions. The argument goes that linkage banking alone cannot meet the demand in other areas of the country.

None of the respondents held the view that the SHG-bank linkage model does not play a very important role in serving poor people. Yet some were of the opinion that, in view of the uneven growth of the SHG-bank linkage model in the country and the vast number of unreached poor, it is appropriate to encourage all models, particularly the initiatives of MFIs pursuing divergent models. Scenario 2 looks at current issues in the regulation of MFIs in India.

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\(^{29}\) There are a number of publications and conference documentations dealing specifically with SHG federations. See, for example, Harper (2002); Sa-Dhan (2002b); APMAS (2003); NABARD (2003); Reddy and Prakash (2003).

\(^{30}\) Some respondents raised the point that the use of federations as intermediaries between banks and SHGs creates additional costs. An interesting case was a federation in Madurai, which prefers to charge an additional service fee on top of the interest payments for loans to SHGs. The rationale is that group members would not understand that they are charged a higher rate for loans from federations than for direct bank loans.
4. Possible Ways Forward

4.2 Scenario 2: Amend Existing Legislation for MFIs

According to scenario 2, more competition from the MFI sector would benefit the poor. The scenario starts from the assumption that the SHG-bank linkage model alone cannot satisfy the huge demand for financial services, and that there is also a role to play for MFIs in the future, particularly in the areas where bank branches are few and far between. A figure frequently quoted originates from the All India Debt and Investment Survey of the GoI (1992). According to this source, the formal financial sector in the early 1990s provided credit support to about 64% of rural indebted households, while informal sources such as landlords, moneylenders, relatives and friends accounted for the rest of the credit needs. This might have changed in the meantime, as the growth of the linkage model only took off later. A view that emerged strongly out of the discussions was that there has been a fall in the percentage of banks’ lending to the poor and that the number of loan accounts below Rs. 25,000 (US$ 560) has come down considerably over the years. No one the consultants talked to questioned that there is still a huge unmet demand for microcredit.

As regards savings, the World Bank in a 2001 report on microfinance came to the conclusion: “The demand is nowhere near being met, particularly for small and frequent savings.” The biggest savings collector in India is Sahara India Financial Corporation Ltd (SIFCL), a Residuary Non-Banking Company (RNBC). It has around 51 million depositors, an asset base of more than US$ 7 billion and around 1,700 branch offices all over India. As an RNBC, at least 80% of its deposit liabilities must be invested in high quality securities as specified by the central bank.

It is felt that there is scope for microfinance models other than the SHG-bank linkage model as some of the MFIs have been very successful in various parts of the country. This goes in line with the instructions issued by the RBI in the wake of the Task Force recommendations, which provide for growth of all viable microfinance models. Some people the consultants talked to recommended having a diversity of institutional models competing with each other. Each of these models could have its own comparative advantage, e.g. serve a specific market niche, offer unique products and services, etc.

The starting point for a scenario, in which MFIs play an equally strong role in the provision of microfinance services as the SHG-bank linkage model, must be the analysis of the current state of the microfinance sector and potential constraints by its legal environment. The MFIs we are talking about are mainly replicators of the Grameen model, NBFCs financing joint liability groups, cooperatives and individuals, credit unions, SHG federations, etc.

Present Challenges and Constraints for MFIs

Among the interviewees, opinions on the future role MFIs might play in serving the poor varied widely, particularly with regard to microfinance NGOs. While some perceived NGO-MFIs to be a transitory phenomenon and did not want them to play a role in financial

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31 To look at this figure might be misleading since the average loan size per SHG is Rs. 28,650, i.e. many loans to SHGs are not included in this figure, although individual loan amounts are far below Rs. 25,000.
32 A RNBC is one type of NBFCs. SIFCL was the first RNBC to be registered with the RBI in 1999.
intermediation (in the Indian usage of the term, i.e. onlending funds from wholesale financial institutions) in the future, others said that their day has not yet come, but that the future will be in NGO-MFIs. It is difficult for NGOs to charge the same low interest rates as banks, yet it was pointed out that NGOs might be better placed to disburse loans quickly and to do doorstep lending, which reduces transaction costs for borrowers.

It is estimated that to date there are only around 20 profitable MFIs in India, none of which started without heavy subsidies from NABARD and/or donor agencies. Some of them explicitly target the poorest (e.g. ASA and CASHPOR), while others target only the poor or even some non-poor. Most of them started off as microfinance NGOs (i.e. societies or trusts), while some have in the meantime converted into Section 25 Companies or NBFCs. The sector benefits from the availability of subsidised government and donor programmes such as the Swarnajayanti Gram Swarojgar Yojana (SGSY), which replaced the earlier Integrated Rural Development Programme (IRDP) by the GoI, or the SIDBI Foundation for Micro Credit (SFMC), which received Rs. 100 crore (US$ 22 million) from DFID alone. NABARD had also earlier supported most of the market leaders at one time or another and is continuing to provide support to many of them through networking NGOs.

Some respondents expressed frustration that, despite the ample availability of financial support, the sector is not really picking up. Problems which were mentioned are weak accounting, a lack of widely agreed upon performance standards, huge capacity building needs, and ultimately poor performance.\textsuperscript{33} These problems make it difficult for MFIs to compete with the SHG-bank Linkage model. It is seen as problematic that the vast majority of microfinance NGOs are multipurpose NGOs offering health, education, nutrition, environment programmes and the like next to microfinance. Estimates are that there are a vast number of multipurpose NGOs (more than 2500), while only a handful of specialised MFIs.

Others were of the view that unless MFIs face a level playing field with the banking sector, they will find it difficult to grow and prosper. According to this argument, regulatory changes must come first and only afterwards can the true potential of this sector be seen. From a regulatory point of view, NBFCs, Section 25 companies and microfinance NGOs are best treated separately. In the following, the main issues raised during the discussions are summarised. The list might not be complete, yet it reflects the views of the practitioners.\textsuperscript{34}

**Issues with Microfinance NGOs**

*Microfinance NGOs* are not under specific financial sector legislation, but under the Societies Registration Act, 1860, and the corresponding Acts of the provincial governments, or under the Trust Act, 1882. Not surprisingly, both State Acts originating from the 19\textsuperscript{th} century lack clarity with regard to NGOs pursuing microfinance operations.

\textsuperscript{33} Sa-Dhan’s Standards Sub-Group is currently working on the issue of uniform performance standards for different types of MFIs.

\textsuperscript{34} Again, the reader is referred to existing literature looking into regulatory issues for microfinance in India (see FN 3).
4. Possible Ways Forward

During the discussions with the consultant team, it was mentioned that microfinance activities of NGO-MFIs are not expressively stated as one of the “charitable purposes” in the preamble to the Societies Registration Act. Furthermore, the carrying out of lending activities against interest can easily lead to the denial of the charitable status. Borrowing and onlending by NGO-MFIs is so far recognised mainly on the basis of executive orders and administrative instructions issued by the RBI and GoI.35

A main constraint for NGOs is the limited availability of commercial funding sources.

- In accordance with Section 45S of the RBI Act, 1934, no unincorporated bodies are allowed to accept deposits from the public. Organisations registered under the Societies Registration Act and the Trust Act are considered unincorporated bodies. The Task Force recommended that for the limited purpose of accepting savings from their clients, NGO-MFIs may be considered as incorporated bodies and excluded from the purview of the Section 45S of the RBI Act, 1934. This recommendation has not found favour with RBI.36 Consequently, the legality of the NGO MFIs mobilising savings from their target clientele is suspect and an issue within the NGO-MFI sector. Looking at international best practice, unregulated NGOs should not be permitted to go into voluntary deposit-taking business - neither from clients nor from the public (cf., for example, van Greuning, Gallardo, and Randhawa 1999).

- If the only kind of deposits accepted by MFIs is cash deposits and if these cash deposits are held in a commercial bank account, international experience does not require prudential regulation of these MFIs.37 In India, MFIs are not permitted to take cash deposits as part of their lending technology, although some of them do.

- Commercial borrowing could be another source of funds for NGO-MFIs. Similar experiences have been made in other countries: NGO-MFIs do not have real owners, i.e. the promoters usually do not have their own money at stake. Banks must therefore basically rely on the past performance of the NGO’s loan portfolio (as the main asset of NGOs) as an indicator for their repayment capacity. In a situation where most of the NGO-MFIs are still young and do not yet cover their full costs, commercial lending is, as one would expect, not easy. An additional problem of NGOs registered as trusts is that a trust legally does not have to pay back a loan if a single trustee has not signed the loan document.

- As shareholder contributions are not an option for NGOs either, the only options left are donor and government funds, the most important being funds from the SFMC. The flow of donor funds is often unpredictable and at times associated with burdensome reporting requirements, which makes it difficult to expand business in a planned manner. Thus a number of NGOs, which initially started under the Societies

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35 In the recent past, agencies have been registered in many states with specific provision to undertake financial activities. The GoI has set up Rashtriya Mahila Kosh (RMK) under its Department of Women and Child development to promote, among other things, microfinance through NGOs. The Ministry of Human Resources Development has also accepted the role of NGOs in providing microfinance. In a recent letter, the Ministry has called on the state governments to assist NGOs in the amendment of their by-laws and thereby facilitate NGO-borrowing for further onlending.

36 On 18th May 2004, the Governor of the RBI clarified this issue in its annual statements on the monetary and credit policy 2004-5: ‘[According to proposals accepted by the RBI,] microfinance institutions would not be permitted to accept public deposits unless they comply with the extant regulatory framework of the RBI.’

Registration Act or Trust Act, have transformed themselves into Section 25 companies or NBFCs.

In practice, many NGO-MFIs collect savings from their borrowers. While such savings do not form the sole basis for their lending operations, MFIs use such funds for onlending along with the funds raised by them from other sources. The RBI is aware of this practice, but has so far not objected to it. It has not explicitly advised against NGOs mobilising savings from their clients, yet neither did it issue any exemption for NGOs from the purview of Section 45S of the RBI Act, 1934. This means that many of the MFIs operate under the threat of being rebuked for mobilising deposits from their clients. The informal group set up by RBI on regulation issues has recommended the conversion of NGO-MFIs into MACS or NBFCs, if they are to mobilise deposits (with a 2 to 3 years transition period).

Another issue of concern for many practitioners is the tax treatment of their lending operations. In most cases, NGO-MFIs are exempted from the Income Tax Act. The crucial question is whether the relevant tax authority acknowledges microlending as a charitable activity. As there is no blanket exemption for all NGO-MFIs, some of the tax authorities are reported to have at times levied taxes on NGO-MFIs. The risk is particularly high if an NGO earns a substantial part of its income from lending activities or, even more so, if it makes a profit (even if the profit has to be reinvested in the business).

**Issues with Section 25 Companies**

Section 25 companies are subject to some similar problems to NGOs. Firstly, even though most Section 25 companies - as not-for-profit institutions - have been exempted from paying income tax for their lending operations, it is understood that, similar to NGO-MFIs, registration under Section 12A of the Income Tax Act, 1961 has not been granted as a matter of routine or principle. The RBI informal group on regulatory issues has recommended complete tax exemption for Section 25 companies purveying microcredit. Donations to MFIs are also to be exempted from income tax. Secondly, Section 25-1A of the Companies Act, 1956, mentions as objectives of such charitable Section 25 companies the promotion of "commerce, art, science, religion, charity or any other useful object". It is not quite clear whether microcredit falls under this definition.

Thirdly, the same restrictions as for NGOs apply to deposit mobilisation for Section 25 companies. Yet differently to NGOs, Section 25 companies have found it easier to access bank loans (although not as much as they would like), and they definitely have an added advantage as they can mobilise equity. Transformation from an NGO into a Section 25 company is easier than into a regular NBFC as the parent NGO can potentially

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38 The relevant legal text is the Income Tax Act (1961), Section 11-4A and 12A. Microfinance must be accepted as an “incidental” business activity for a NGO to be tax-exempt.

39 Some of the respondents even questioned whether Section 25 companies are legally permitted to lend. This depends on the interpretation of Section 45S of the RBI Act.

40 As of now the Section 25 companies have mostly been set up by eminent microfinance practitioners who had been running NGOs with very good reputation. They have been able to procure funds mostly from donors, financial institutions like NABARD and SIDBI, and from banks on the basis of the good work of the NGOs.
invest in the share capital of a Section 25 company (see below for NBFCs). The informal group set up by the RBI recommended that the Company Law Board may allow SHGs to be members of the Section 25 companies.

Finally, although microfinance defined by the Task Force and accepted by RBI provides for financial services of very small amounts, the RBI instructions exempting Section 25 companies from registration and reserve requirements for NBFCs stipulate that loans should not exceed Rs. 50,000 (US$ 1,100) for non-housing purposes and Rs. 125,000 (US$ 2,800) for housing purposes.\textsuperscript{41} An issue which still remains to be clarified, is whether the ceiling applies to individuals or the group as a whole. Taking into account that many SHGs have already received larger amounts than Rs. 50,000 from banks, it is presumed that the ceiling of Rs. 50,000 and Rs. 125,000 for relevant purposes is meant to be applicable for individual members of the SHGs.\textsuperscript{42}

Section 25 companies are required to submit their annual accounts to the Registrar of Companies. Apart from this, there is at present no external regulation for these companies. The general feeling among microfinance practitioners is that there is no need for prudential regulation as the financing banks, in the ordinary course of their activities, will insist on filing of charges with the Registrar of Companies and will also keep a tab on the holding of board meetings and submission of inventories statements, etc.

Some practitioners feel the need for better fund management of Section 25 companies. Even though the traditional arguments for prudential regulation – to protect deposits and to ensure the stability of the financial sector – might not hold for credit-only Section 25 companies, there is a risk that poor fund management might lead to deteriorating repayment performance. Ultimately, the access to fresh loans is the main incentive for paying back previous ones.\textsuperscript{43} Furthermore, some practitioners informed that they had developed their own asset classification, income recognition and provisioning norms for their loans to SHGs.\textsuperscript{44}

### Issues with NBFCs

Finally, NBFCs are the only type of MFI falling clearly under the purview of the central bank and being subject to prudential regulations. A number of NGOs have recently set up for-profit NBFCs – Bharatiya Samruddhi Finance Limited as part of the BASIX Group, SHARE Microfin and CASHPOR Financial & Technical Services Ltd. (CFTS) are prominent among them. These leading three NBFCs disburse 76 percent of all loans of NBFCs in microfinance. As for-profit companies, they have to pay income tax on their lending operations.


\textsuperscript{42} Mahajan/Ramola (2003) criticise the limit of 125,000 for housing loans, i.e. as loans for “a dwelling unit”, as being too high.

\textsuperscript{43} One of the promoting NGOs is planning to set up an Asset Management Company with an autonomous and independent board in due course, which would as a wholesale financial institution exert some control on the Section 25 companies that would be set up by it in future.

\textsuperscript{44} Interestingly, some NGOs promoting SHGs for the SHG-bank linkage model, have founded their own Section 25 companies (e.g. Kalanjiam Development Financial Services, KDFS, or Sanghamithra). According to the NGOs, the main objective is to show banks that linkage banking can be an interesting business opportunity.
Practitioners raised a number of regulatory challenges for NBFCs:

- The minimum capital requirement for a licence as a NBFC was one of the issues brought up by the MFI sector. It currently stands at Rs. 20 million (US$ 450,000), which is considered to be quite high. While this figure seems not to be too high in comparison with other countries (cf. Staschen 2003b: Table 3), NBFCs are restricted by having to bring in the capital as fresh money. NGOs are not allowed to invest capital in a non-charitable institution. Thus the most common route in other countries to set-up a for-profit MFI – the parent NGO investing its net-worth in a newly founded institution - is apparently closed for Indian NGOs.

- As per the available information, none of the NBFCs engaged in microfinance so far accepts deposits from its clients.\(^\text{45}\) It is presumed that there may not be many such NBFCs interested in accepting deposits. This may be partly due to the stringent requirements imposed by the RBI. Deposit taking by NBFCs is generally possible only after three years of registration. NBFCs must receive an investment grade rating from any of the four accredited rating agencies in India. Further, NBFCs are allowed to accept only time deposits for periods from one to five years, subject to an interest rate ceiling (11% at present). Another regulation stipulates that mobilisation of deposits up to Rs. 500 million are only allowed in the province of registration.\(^\text{46}\) Finally, NBFCs need to have branches or may have to appoint agents to collect deposits. It is necessary for the NBFCs to seek RBI permission for opening branches.

- The RBI has announced very stringent norms for the NBFCs who wish to take up insurance business. Thus the microfinance-NBFCs cannot take up insurance business or transfer of funds, etc.

- The GoI has allowed foreign equity investment in NBFCs subject to a ceiling of 51% and a minimum amount of US$ 500,000. There is a feeling among the MFIs that this amount is on the high side. As regards full foreign ownership of NBFCs, the minimum amount prescribed by GoI is US$ 5 million, which is considered out of reach for the microfinance sector. As a result, not many investors are reportedly showing interest in equity contributions to microfinance NBFCs.

- RBI currently undertakes the supervision of NBFCs engaged in microfinance. Some microfinance practitioners made the proposal to delegate supervisory tasks to a as-yet-unidentified third party, which would act as an agent for RBI. The Reserve Bank probably does not expect many more MFIs to get a licence as deposit-taking NBFCs. Furthermore, it was mentioned that the capacity of the central bank to supervise many microfinance NBFCs should be taken into account. In 1998, the Task Force recommended the development and grooming of self-regulatory organisations (SROs) for assisting the RBI in the regulation and supervision of MFIs. But at present, the microfinance practitioners are not very positive about the role of SROs in the regulation and supervision of microfinance. So far, there has been hardly any

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\(^\text{45}\) Seemingly, two NBFCs fulfil all formal requirements for carrying on deposit-taking business, but have not started doing this yet.

\(^\text{46}\) This is apparently a problem for one of the NBFCs, which is registered in a different state than where its main business is located.
movement in the promotion of SROs. Even Sa-Dhan, the association of MFIs in India, has not taken any positive move in this regard.\textsuperscript{47}

- In the legislation, nine types of NBFCs are distinguished between, yet none of these is a 'microfinance NBFC'. The Task Force has recommended the creation of a separate type of NBFC, yet the RBI has apparently not accepted this recommendation. According to the discussions of the consultant team with the RBI, MFIs are free to apply for an NBFC licence under the currently available legal provisions.

- Finally, interest rate caps can be introduced by state governments under existing state legislation. This was, for example, recently the case in one state, where not only moneylenders, but also MFI-NGOs, were at risk of being punished if charging interest rates higher than 12%.\textsuperscript{48}

**Regulatory Changes Advocated for by the Discussants**

As a consequence of these constraints and challenges stated by practitioners during the discussions with the consultant team, the following are some potential regulatory changes one or the other interview partner has advocated for:\textsuperscript{49}

- Savings mobilisation for NGO-MFIs could be allowed subject to certain limits (e.g. from borrowers only, up to a certain cut-off limit) and minimum reporting requirements.\textsuperscript{50}

- Alternatively, NGOs could be allowed to deposit surplus savings from their clients with commercial banks, as long as they do not lend them out.

- A common view was that NGOs should be allowed to invest in the equity of NBFCs as these would facilitate the transformation into formal financial institutions.

- A clarification would be helpful that the lending limit of Rs. 50,000 for Section 25 companies/NGO-MFIs does refer to individual borrowers, not to a group as a whole.\textsuperscript{51}

- Some people argued that the present four accredited rating agencies do not give sufficient consideration to the specific characteristics of MFIs. According to them, it would be better to accredit other agencies with microfinance-specific ratings. The informal group constituted by the RBI recommended accepting the special credit rating tools developed for the MFI sector.\textsuperscript{52}

- The majority of interviewees advocated a lower minimum capital requirement of Rs. 2.5 million (US$ 56,000) at least for the non-deposit taking NBFCs as the Task Force already advocated 5 years ago. Yet it is apparent that the RBI is not in favour of lowering the minimum capital requirement for NBFCs regardless of whether they

\textsuperscript{47} An exception in this regard is INAFI India, the International Network of Alternative Financial Institutions. One of the fields INAFI is currently working on is a self-regulatory system for microfinance. They organised a workshop on this on September 26-27, 2002, in Lucknow.

\textsuperscript{48} Discussions are still ongoing and the ceiling might be raised to 24% in the near future.

\textsuperscript{49} Cf. the very similar recommendations in Sa-Dhan (2002a).

\textsuperscript{50} Cf. the recommendations of the Task Force. It should be stressed again that this recommendation does not go in line with most other publications on microfinance regulations.

\textsuperscript{51} The same was recommended by the informal group set up by the RBI.

\textsuperscript{52} Currently, two rating agencies offer specialised microfinance ratings, one of which is one of the four accredited rating agencies. Yet NBFCs must be subjected to a traditional rating process to qualify for deposit-taking.
are deposit-taking or not. The RBI appointed informal group on regulation has repeated the recommendation to have a separate category of non-deposit taking NBFCs with a minimum capital of Rs. 2.5 million, while those accepting deposits may remain the same, i.e. Rs. 20 million.

- With regard to foreign investments, one proposal is to reduce the minimum amount to US$ 50,000.

Some people argued that this is a relatively long list of changes still pending and that it might take a long time to actually implement them. According to this view, a ‘piecemeal approach’ like the one advocated for by this scenario 2 might not be the best way to go. Most of the problems are well documented, yet not much change could be observed recently. A better alternative, so they say, might be to aim towards a new special law for microfinance. This leads us to scenario 3, i.e. the introduction of a special law for microfinance.

### 4.3 Scenario 3: A New Special Law for Microfinance

As already mentioned, microfinance activities in India are covered under a number of different acts and regulations, many of which are very old and not specifically meant for microfinance. There is a feeling among many microfinance practitioners that a special and separate exclusive law for microfinance could be very useful for the growth of microfinance activities.

This chapter looks at the following topics:

- A list of institutional forms, which are currently available for doing microfinance;
- The problem of regulatory arbitrage;
- The ambit of a new special law for microfinance; and
- The importance of sufficient political support for the introduction of a new law.

Other than for scenarios 1 and 2, this section relies to a lesser degree on the consultants’ discussion with stakeholders in India and more on international experience with introducing a special law for microfinance. This is simply due to the fact that the discussions about a separate microfinance law were not yet as much advanced as the discussions relating to the two other scenarios. Another reason might be that a number of people do not think that a special microfinance law is needed in India.

#### Number of Different Institutional Forms Available for Doing Microfinance

Two basic approaches to regulate financial institutions can be distinguished, viz. institutional and functional regulation. While institutional regulation stipulates regulatory requirements depending on the type of institution, functional regulation regulates specific financial activities – microfinance being one of them – irrespective of the type of institution that undertakes these activities. India follows the approach of institutional regulation. In addition to commercial banks, RRBs and LABs, NBFCs, Section 25 companies, trusts and
societies, and the different types of cooperatives, there are two other institutional forms open for the provision of microfinance services that should be touched upon briefly. 

*Mutually Aided Cooperative Societies* (MACS) are a relatively new form, regulated under special state legislation for MACS. Entry and ongoing regulatory requirements are fairly low, supervision is light and performance varies. What makes MACS an attractive form is the much lower government control of their operations than for other cooperatives and the possibility to mobilise deposits from members. A number of different institutions received a licence as MACS. In Andhra Pradesh, MACS became the favoured institutional form for SHG federations. For more information on MACS see Annex 3.

There is the relatively recent institutional form of a *Local Area Bank* (LAB), of which one of the currently four licensed LABs specialises in microfinance. LABs are private sector commercial banks operating in rural areas. They are covered by RBI's guidelines on regulation and supervision. There were expectations in the beginning that this form might be an interesting vehicle for providing microfinance services. Yet it is evident that there are a number of regulatory provisions making this form not particularly attractive for microfinance:

- The area of operation is restricted to not more than three districts;
- RBI is reportedly very closely monitoring the operations of the only Local Area Bank with exclusive microfinance business;
- A particular difficulty faced by LABs doing microfinance is the RBI instruction of a cap on unsecured lending of 15% of total advances;
- For doing microfinance, the documentation requirements are comparatively onerous; and
- The minimum capital requirement of Rs. 50 million (US$ 1.1 million) to be brought upfront is perceived as being high.

None of the laws governing these different types of institutions explicitly mentions the term microfinance or microcredit. The argument goes that the introduction of a separate law may be a way to streamline the relevant provisions of current laws.

**Risk of Regulatory Arbitrage under Current Legal Framework**

In theory, the degree of external oversight by the regulatory authority should depend on the type of business activity undertaken by the financial institution. The ‘risk-based approach’ follows the rule: the higher the risk, the tighter the regulations (cf. Fitzgerald and Vogel 2000). Institutional regulation is subject to the risk of regulatory arbitrage, which is the process of looking for the institutional form with the lowest regulatory requirements, even if this form was not originally meant for the kind of business the institution is undertaking. This is the difference between the spirit of the law (what lawmakers had in mind while drafting legislation) and the letter of the law (what is legal).
The consultant team learnt of different ways to offer clients savings services without being subject to the stringent requirements for NBFCs. Cooperative forms such as Mutual Benefit Trusts or MACS can mobilise deposits from their members, yet the degree of regulatory control is much lower than for NBFCs. If the clients of NBFCs become members in one of these cooperative forms, they can also deposit their savings with the cooperative. Other than microfinance NGOs, these cooperatives can become shareholders in NBFCs. Alternatively, they can onlend the accumulated savings to the NBFC. Both these ways allow NBFCs to tap borrowers' savings as an additional source of funds and to offer their customers new savings facilities. It should be stressed that not all depositors might be aware of the conversion of small savings into equity and what this means for them.

**Potential Ambit of a Special Microfinance Law**

An important aspect of a regulatory framework for microfinance is the clear definition of the lower and upper boundaries of the prudentially regulated microfinance tier (cf. Christen, Lyman, and Rosenberg 2003: 16ff.). Evidence from other countries shows that in Uganda a separate law has been made only for deposit-taking MFIs, while a separate law for all kinds of MFIs has been promulgated in Kyrgyzstan. Such all-encompassing microfinance law usually distinguishes between several tiers, which are subject to different degrees of external regulation.

Judging from the current discussions in India, it seems not yet to be clear which MFIs should be covered under the legislation – only the deposit-taking MFIs, Section 25 companies and NGO-MFIs or even banks' with microfinance portfolios. It is doubtful whether the commercial banks, RRBs and the cooperative banks, as important players in the microfinance sector could in any beneficial way be covered under the Act. Going for a functional regulation - i.e. a new law which covers all microfinance activities irrespective of the institutional form under which it is offered - the first step would be to clearly define microfinance from a regulatory point of view. International experience shows that this is a multi-dimensional task (cf. Staschen 2003b: Ch. 2.2.2). The outcome could be to introduce a tiered structure of MFIs with different levels of sophistication, different numbers of products to be offered (credit-only, term deposits, savings, insurance, etc.) and varying degrees of regulatory oversight.

According to some discussants, it is feared, however, that the proposed new legislation will further complicate the already complex legal environment for microfinance. It was stressed by some people that there is no lack of laws in India - enforcement of the laws and clear separation of legal frameworks are the real issues. In this regard an important question will be whether the new Act supersedes existing laws, or just adds another law those already existing.

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53 It is important to stress that regulatory arbitrage is nothing illegal, but simply a way to use the existing laws in a way, which suits the business to be undertaken best.

54 This brings the added advantage of having a much smaller number of shareholders of the NBFC. Instead of having thousands of clients as shareholders, it is only a small number of, for example, Mutual Benefit Trusts, which are shareholders of the NBFC.

55 See also Annex 3 for some more information on MACS.
4. Possible Ways Forward

Political Support for New Law

As of now, it appears that both the GoI and the RBI are not very keen to introduce a new Act. Experience from other countries shows that the introduction of totally new legislation of this type requires political conviction and a lot of staying power. In view of this complex legal and political process, there was a feeling among some interviewees that the addition of a few provisions on microfinance in some of the existing Acts, as described in scenario 2, could be a better alternative. In Bolivia and Indonesia, special microfinance-specific statutory regulations have been brought in under the already existing general banking law. An important aspect will be the definition of MFIs to be covered and thus the number of institutions to be regulated under this new Act, as legislating for only a few NBFCs is seen as a burdensome task.

The Task Force recommended a new chapter in the RBI Act on MFIs. This has not found favour with RBI. Instead, the RBI through its instructions dated 18th February 2000 has recognised microfinance as part of the lending activities of the banks with the message that savings services would be provided by the banks and other incorporated approved institutions.

There is a sense of insecurity particularly among those NGO-MFIs who are implementing the Grameen model and are mobilising savings from their clients. Regulation in any form, either through a separate law or an additional chapter in any Act, would provide them with much-desired recognition of their activities.

Finally, there is currently the Financial Companies Regulation Bill (Bill No. 196 of 2000) pending before Parliament, which was introduced in the Lok Sabha (the Lower House of Parliament) on December 13, 2000.56 This Bill will for the first time introduce a separate Act for NBFCs and thereby streamline legal provisions for NBFCs. It remains to be seen how the final Act will look like. The fact that this is still only a Bill might even open the opportunity to include some microfinance-specific provisions under this Act.

5. A Look at Relevant International Experience

Looking at international experience with different approaches to microfinance regulation, a number of concluding remarks can be made. In addition, possible next steps can be identified by looking at the regulatory debate in other countries.

None of the countries with a mature microfinance sector is relying on a single model to provide microfinance services. In Bolivia, Private Financial Funds, Open Savings and Loan Cooperatives and even a commercial bank are the main sources of financial services for the poor. Ghana has both Regional Rural Banks and Savings and Loan Cooperatives serving the microfinance market. In Indonesia, there are BPRs, BKDs and LDKPs and, of course, the Village Units of Bank Rakyat Indonesia (BRI). An important lesson seems to be that a variety of institutional forms helps to reach more people.

The same is true for India: It will be important to improve on safeguards of the SHG-bank linkage model against potential future risks. But at the same time, the various types of MFIs can potentially play a stronger role in the future. Looking at other countries' experience, one can see that mature customers become more and more interested in individual loans, easy access to flexible savings facilities and even other financial services like money transfers and insurance products. Thus the limitations of the linkage-banking model in terms of size of products (large loans and savings accounts), number of different products and scope for diversification might become restrictive for more successful members of SHGs. It can be argued that these members can turn into attractive individual customers of the bank branches, thus having access to a wider range of products.

Looking at alternative institutional models, it is unlikely that NGO-MFIs can step in. They play an important role in the provision of microcredit especially in remote areas, but should not go into the savings business. Even giving them the permission to deposit surplus savings of SHGs or individual customers with formal banks involves considerable risk. Consensus among regulation experts is emerging that cash deposits as a prerequisite of accessing loans might be permitted (subject to a certain percentage limit to ensure that most clients are most of the time net-borrowers with the institution), but all other savings products trigger the need for prudential regulation (Hannig and Omar 2000). It is not easy for NGOs to overcome funding constraints. One way might be to transform into Section 25 companies, which have better access to commercial sources of funds.

From the Government’s side, not much action seems to be required except for the clarification of tax status. Self-regulation can potentially play a role for non-deposit taking NGO-MFIs. Setting uniform performance standards, improving market transparency and educating consumers are important preconditions for a self-regulatory system.57

With regard to NGOs borrowing money on the market and lending it out to SHGs/individuals, there is no clear need for prudential regulation. South Africa distinguishes wholesale and retail deposits taking (Staschen 1999). Only the latter triggers

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57 Cf. a recent proposal for the regulation of Uganda’s credit-only MFIs and savings and credit cooperatives: Staschen (2003a).
a need for prudential regulation, while the former can rely on the control exerted by the lending institution.

An estimated 20 MFIs in India are profitable. This is still a small number given the size of the country. A very successful model in other countries is to transform from an NGO into a formal financial institution. In India, either LABs or NBFCs could be an interesting legal form to transform into. Yet current restrictions with regard to deposit taking, foreign equity investments and NGOs becoming shareholders in non-charitable companies render this a much less attractive option.

There is a risk of licensing too many MFIs or those which are too weak. In countries like the Philippines and Ghana, the large number of rural banks has become a strain on the central bank’s supervisory capacity. Further, international experience shows that achieving economies of scale is important to become financially self-sufficient. This argues for a cautious approach in licensing new MFIs going hand in hand with building additional supervisory capacity. The delegation of the supervisory task to a third party does not by itself solve the problem of limited supervisory capacity, as this third party also needs to be supervised by the regulatory authority (i.e. the RBI).  

Overall, the costs and benefits of different institutional models serving the microfinance market can be an important guideline in deciding about the best legal framework. This is not only the institutional costs (the costs for the supervisor) and the compliance costs (the costs for MFIs to comply with regulatory requirements), but also structural costs such as the costs of setting up high barriers to entry for new financial institutions. In such a situation potential customers might miss the benefit of having better access to microfinance. This is difficult to predict as one is talking about a hypothetical situation no one has ever tried (i.e. easing market access for new entrants). While the costs and benefits of regulating banks involved in lending to SHGs can at least be estimated, it is difficult to predict what the costs and benefits of a higher number of prudentially regulated MFIs would be.

In most countries, there is at least a second ‘tier’ of financial institutions next to the commercial banks. Setting up a new microfinance law would mean introducing another tier. Some countries have successfully done so. But one should be aware that this could be a demanding and time-consuming exercise. Christen and Rosenberg (2000) have stressed two important points: In many countries, the main bottleneck is not the absence of a microfinance-specific law, but the lack of MFIs suitable for licensing under such a law. Secondly, it might be preferable to use an existing legal structure and adapt it, even if it was not specifically created for microfinance. In any case, it would be essential to adopt a structure that takes the Indian current legal framework and experiences in microfinance into account.

India has a relatively small number of licensable MFIs and its regulatory framework offers two legal forms which could be used by MFIs, namely the LAB and NBFC structure. As

58 Cf. the reservations of Berenbach and Churchill (1997: 67) regarding the delegation of the supervisory tasks to a second-tier institution.
mentioned earlier, both are not without their flaws when it comes to the provision of microfinance services. Yet it might be the better option to start from one or the other rather than to introducing a completely new law.

Finally, there is still a need for improving the access of poor people to savings facilities. The success of the Sahara India Financial Corporation (SIFCL) is an example that savings mobilisation and lending must not necessarily be undertaken by one and the same institution. A specialised savings collector like SIFCL does not pose a great risk to the financial sector. It follows the narrow-banking concept, according to which banks are required to back demand deposits entirely by safe short-term assets. The huge unmet demand underscores the fact that banks may have to take more initiatives in providing savings services to SHG members than their routine savings bank accounts.

There has not yet emerged something like a best practice as to how to achieve an appropriate legal environment for microfinance. Political processes differ from country to country. Evidence from other countries tells us that consultation of all relevant stakeholders is important. On the other hand, too much consultation can lead to an unwelcome delay of the process. In India, there already exist bountiful studies on the legal environment for microfinance. What is required now is a decision on the general approach and then the implementation of the necessary changes.

\[59\] An important lesson from Uganda is that the Parliament should be involved from the beginning. Ultimately it is its members who have to vote on a bill for a new or amended law.
Annexes

Annex 1: List of Persons Interviewed

Annex 2: Development of SHG-Bank Linkages

Annex 3: MACS as Alternative Legal Form
## Annex 1: List of Persons Interviewed

<table>
<thead>
<tr>
<th>DATE</th>
<th>NAME</th>
<th>POSITION</th>
<th>INSTITUTION</th>
</tr>
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<tbody>
<tr>
<td>7/10/2003</td>
<td>Shri A.V. Sardesai</td>
<td>Executive Director</td>
<td>RBI, Mumbai</td>
</tr>
<tr>
<td></td>
<td>Shri V.S.N. Murthy</td>
<td>Chief General Manager</td>
<td>RPCD, RBI</td>
</tr>
<tr>
<td></td>
<td>Smt. Dipali Pant Joshi</td>
<td>General Manager</td>
<td>RPCD, RBI</td>
</tr>
<tr>
<td></td>
<td>Shri Muralidhar Rao</td>
<td>General Manager</td>
<td>NABARD</td>
</tr>
<tr>
<td></td>
<td>Shri H.R. Dave</td>
<td>Deputy General Manager</td>
<td>NABARD</td>
</tr>
<tr>
<td></td>
<td>Dr. Jindal</td>
<td>Deputy General Manager</td>
<td>NABARD</td>
</tr>
<tr>
<td>8/10/2003</td>
<td>Shri Narendra</td>
<td>Programme Leader</td>
<td>DHAN Foundation, Madurai</td>
</tr>
<tr>
<td>9/10/2003</td>
<td>Shri M. Kalyansundaram</td>
<td>Main Coordinator</td>
<td>INAFI, Madurai</td>
</tr>
<tr>
<td></td>
<td>Smt. Lata</td>
<td>Chief</td>
<td>Madurai Vattara Kalanjiam (A Federation of SHGs)</td>
</tr>
<tr>
<td></td>
<td>Yelli Muniandi</td>
<td>SHG leader</td>
<td>SHG in Madurai</td>
</tr>
<tr>
<td>10/10/2003</td>
<td>Shri Varadarajan</td>
<td>CEO</td>
<td>IDPMS, Bangalore</td>
</tr>
<tr>
<td></td>
<td>Shri Tyagrajan</td>
<td>Secretary</td>
<td>Microcredit Network</td>
</tr>
<tr>
<td></td>
<td>Shri A. Radhakrishnan</td>
<td>Co-ordinator, Microfinance,</td>
<td>Outreach</td>
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<tr>
<td></td>
<td>Shri Suresh</td>
<td>Chief Operating Officer</td>
<td>Grameen Kootoa</td>
</tr>
<tr>
<td></td>
<td>Mrs. Vinatha M. Reddy</td>
<td>Managing Trustee</td>
<td>Grameen Koota</td>
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<tr>
<td>11/10/2003</td>
<td>Shri A.L. Fernandez</td>
<td>Executive Director</td>
<td>MYRADA</td>
</tr>
<tr>
<td></td>
<td>Ms. Yasmin Merchant</td>
<td>Programme Director</td>
<td>MYRADA</td>
</tr>
<tr>
<td>12/10/2003</td>
<td>V.N. Bhatt</td>
<td>Former Executive Director</td>
<td>Sanghamithra, Bangalore</td>
</tr>
<tr>
<td>13/10/2003</td>
<td>Shri K. Seshadri</td>
<td>Chartered Accountants</td>
<td>Bangalore</td>
</tr>
<tr>
<td></td>
<td>Smti. Sunanda P. Seshadri</td>
<td>Chartered Accountants</td>
<td>Bangalore</td>
</tr>
<tr>
<td>14/10/2003</td>
<td>J.R. Sarangal</td>
<td>Chief General Mgr.</td>
<td>NABARD</td>
</tr>
<tr>
<td></td>
<td>Shri T. Ramachandra Reddy</td>
<td>Deputy General Manager</td>
<td>Andhra Bank Head Office, Hyderabad</td>
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<tr>
<td></td>
<td>Shri Ramakrishna</td>
<td>General Manager</td>
<td>Sanghameshvara Grameen Bank, Mahaboobnagar</td>
</tr>
<tr>
<td></td>
<td>Shri A.K. Khan</td>
<td>Sr. Manager</td>
<td>Rayalaseema Gr. Bank, Kadapa, Andhra Pradesh</td>
</tr>
<tr>
<td></td>
<td>Shri Vishwanatha Prasad</td>
<td>Managing Director</td>
<td>Bhartiya Samruddhi Finance Ltd, BASIX, Hyderabad</td>
</tr>
<tr>
<td>15/10/2003</td>
<td>M.S. Udaya Kumar</td>
<td>Managing Director</td>
<td>SHARE, Hyderabad</td>
</tr>
<tr>
<td></td>
<td>Shri K. Vijayratnam</td>
<td>Asst. Project Officer</td>
<td>DRDA, Ranga Reddy District, Andhra Pradesh</td>
</tr>
<tr>
<td></td>
<td>Keesara MACS</td>
<td>Entire Board</td>
<td>MACS (Federation of SHGs)</td>
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<tr>
<td>16/10/2003</td>
<td>Shri V. Satayamurthy</td>
<td>Chief Executive Officer</td>
<td>AIAMED, New Delhi</td>
</tr>
<tr>
<td>17/10/2003</td>
<td>Shri N.S. Sisodia</td>
<td>Secretary (Banking)</td>
<td>Ministry of Finance, Govt. of India</td>
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<tr>
<td></td>
<td>Shri G.C. Chaturvedi</td>
<td>Joint Secretary (Banking)</td>
<td>Ministry of Finance, Dept. Of Economic Affairs, Banking Division</td>
</tr>
<tr>
<td>DATE</td>
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<tr>
<td></td>
<td>Shri Mathur</td>
<td>Economic Advisor</td>
<td>Ministry of Finance, Dept. of Economic Affairs, Banking Division, Govt. of India</td>
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<tr>
<td></td>
<td>Smti K.C. Rajani</td>
<td>Deputy General Manager</td>
<td>SIDBI, Lucknow</td>
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<tr>
<td></td>
<td>Shri Faisal Baig</td>
<td>Head – India Division</td>
<td>CIDA</td>
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<td></td>
<td>Shri D.Narendranath</td>
<td>PRADAN</td>
<td>New Delhi</td>
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<td></td>
<td>Shri Mathew Titus</td>
<td>Executive Director</td>
<td>SA-DHAN, New Delhi</td>
</tr>
<tr>
<td></td>
<td>Smti. Archana</td>
<td>Programme Director</td>
<td>SA-DHAN</td>
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Annex 2: Development of SHG-Bank Linkages

The agency-wise distribution of number of SHGs financed up to 31 March 2003 was as below:

<table>
<thead>
<tr>
<th>AGENCY</th>
<th>SHGs</th>
<th>BANK LOANS</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>%</td>
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<tr>
<td>(Amounts in million US$)</td>
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<td></td>
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<tr>
<td>Commercial Banks</td>
<td>361,061</td>
<td>50</td>
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<tr>
<td>Regional Rural Banks</td>
<td>277,340</td>
<td>39</td>
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<tr>
<td>Cooperative Banks</td>
<td>78,959</td>
<td>11</td>
</tr>
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</table>

Source: Progress of SHG-Bank Linkage in India 2002-2003, NABARD.

Thus, for all 27 public sector banks and 21 private sector banks the SHG-bank linkage model became a part of their business. More than 97% of the RRBs in the country participated in the linkage programme. As a result of the amendments made by many of the state governments to the State Cooperative Acts, SHGs could become members of Primary Agricultural Credit Societies (PACS), enabling the cooperative banks to provide banking services to SHGs through PACS. The trend in the growth of the SHG-bank linkage model over the years was as below:

<table>
<thead>
<tr>
<th>YEAR</th>
<th>FINANCING OF SHGs</th>
<th>BANK LOANS</th>
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<tbody>
<tr>
<td></td>
<td>During the Year</td>
<td>Cumulative</td>
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<tr>
<td>(Amounts in million US$)</td>
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<tr>
<td>1992-1999</td>
<td>733</td>
<td>733</td>
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<tr>
<td>1999-2000</td>
<td>1,817</td>
<td>2,551</td>
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<tr>
<td>2000-2001</td>
<td>3,312</td>
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<td>2001-2002</td>
<td>4,392</td>
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<tr>
<td>2002-2003</td>
<td>5,686</td>
<td>15,941</td>
</tr>
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</table>

Source: Progress of SHG-Bank Linkage in India 2002-2003, NABARD.

As of 31st March 2003, the total number of participating NGOs and other agencies stood at 2,800. The wide outreach and the human resources available with the formal and government agencies at the field level were effectively tapped by the SHG-Bank Linkage Programme for forming and nurturing SHGs. Over time, an increasing number of formal agencies including development departments of the state governments and banks have come forward as Self Help Promoting Institutions (SHPIs), i.e. as institutions promoting new SHGs.
Annex 3: MACS as Alternative Legal Form

In India, the government has in many states controlled the cooperatives to a great extent. But from the mid-1990s, there has been growing demand in a number of states for the creation of truly member-controlled cooperatives without share capital contribution from government and reduced government control in the administration of cooperatives. As a result, new cooperative laws have been enacted in many states like Andhra Pradesh, Bihar, Orissa, Jammu & Kashmir, etc. In Andhra Pradesh, under the new Act, viz. the Andhra Pradesh Mutually Aided Cooperative Societies Act (APMACS Act), about 3000 societies are reported to have been formed, of which about 1800 are involved in microfinance. Most SHG federations in the state of Andhra Pradesh have registered themselves under this new Act. Also a large number of chit funds (a kind of rotating savings and credit association) have apparently applied for registration as MACS.

Since the societies registered under the new Act are treated as incorporated bodies, they can - as per the provision of the Act - carry out financial transactions of all types, viz. savings mobilisation from their members, credit, insurance, and housing. So the major constraint for NGO-MFIs, i.e. not being allowed to mobilise savings from their clientele, does not apply to MACS under the new Act. Since SHGs are not recognised as a legal entity, they cannot be member of a MACS. Only individuals are allowed as members.

There is no minimum share contribution by the members stipulated. Registration only requires minimal funds (one figure mentioned to the consultants was Rs. 500, i.e. US$ 11). In light of the possibility of having only very low share contributions, the main dividing line between a cooperative society and an NGO, i.e. the cooperative being owned by its members, seems to be blurred. It is usually the strong internal control by members having a financial stake in the cooperative which serves as justification for permitting savings mobilisation from members.

MACS in Andhra Pradesh are regulated by the government department as regards their day-to-day operations and are required to file their accounts with the Registrar of Societies.

The societies under the new MACS legislation like the APMACS Act currently enjoy a very light supervisory regime. Due to this, a number of other financial institutions including NBFCs have reportedly started routing the savings of their clientele to their main business through the federations of SHGs, which are registered as MACS. There are also allegations that under the guise of mutual help, unscrupulous elements are taking advantage of the ignorance of poor women and are managing the savings of the poor for purposes other than mutual help, virtually without any worthwhile supervision.

Monitoring arrangements in regard to the MACS are quite weak, as a large number of the societies are reported to have not submitted their financial statements to the Registrar. Banks have, in certain states, come together along with other practitioners to develop

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60 Some discussants favoured the recognition of SHGs as a legal body to allow them to become members of MACS. Yet by many others the informal character of SHGs is seen as one of their strongest points.
common guidelines for their financing, based on best practices. The state government of Andhra Pradesh has for its part issued instructions to the federations promoted by it to observe best practices in regard to governance, management, etc., to enhance their bankability.

MACS are a rapidly developing institutional form. It would be helpful to do a study on quality of MACS and MACS' supervision, perhaps starting with Andhra Pradesh, which has the most advanced MACS sector in India. Such a study could evaluate the potential and risks of MACS from a regulatory point of view.
References


