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Regulating Microfinance Institutions in India

Need for Reforms

Santadarshan Sadhu, Kenny Kline, & Justin Oliver

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Author Bio:

Santadarshan Sadhu, Centre for Micro Finance, IFMR

Kenny Kline

Justin Oliver

Published By:

CUTS Institute for Regulation and Competition
R 75, First Floor
Greater Kailash I
New Delhi 110048
http://circ.in
circ@circ.in
+91 11 26463021/22/23

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1. Introduction

Microfinance institutions, (MFIs), have become increasingly important for meeting financial inclusion goals in developing countries. According to Consultative Group to Address the Poor (CGAP), only 30 per cent of adults in developing countries are estimated to have access to basic deposit services and even fewer to credit, insurance and other financial services. Consequently, the poor have to rely on more costly informal financial services to save and to borrow. MFIs straddle this chasm. Currently MFIs in India serve 31.4 million clients, with ₹207.5bn loans outstanding.[1] These institutions aim to provide services to poor clients, maintaining an average loan size under ₹ 10,000.

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

In 2009-10, around 691 MFIs were provided loans worth ₹80.63bn by banks. The growth under MFI-linkage programmes in terms of both number of credit-linked institutions and the amount of loans was much higher than the corresponding growth under SHG-bank linkage programmes. However, though MFIs have grown at tremendous rates, the growth has been geographically disproportionate. The Malegam Committee[2] report noted that distribution of microfinance penetration is very high in the Southern region, while the Western and Northern regions show very little penetration. Southern region has a little over half of the total MFI portfolio while the Eastern region has over one fourth of the total MFI portfolio. SHG penetration shows a similar trend. Even within regions, microfinance services are often concentrated in certain districts. The report, however, shows the encouraging trend of MFI diversification into other regions at a rate of growth comparatively higher than the rate of growth in the Southern region.

The MFI model in India is implemented primarily through private initiative. In the 1980s, MFIs took the form of societies, trusts, and local area banks. The enactment of Mutually Aided Cooperative Societies (MACS) Act at state level in some of the states like Andhra Pradesh, in 1990s permitted registration of cooperatives and provided permission to lend. MACS enjoy the advantages of operational freedom and virtually no interference from government because of the provision in the Act that societies under the Act cannot accept share capital or loan from the state government.[3]

As these MFIs grew in size, many transformed to become NBFCs. NBFCs must adhere to more stringent audit and disclosure requirements, which make them more suitable for performing financial operations and for attracting additional funding through capital markets. Also of importance is the SHG- Bank Linkage Model (SHG Model), which was started in 1991 by the National Bank for Agriculture and Rural Development (NABARD). The model was quickly adopted by banks, and by 2005 over one million SHGs were a part of the linkage model. Currently, 62.5 million clients are linked to banks through SHGs, with ₹306.2bn loans outstanding. The scope of this paper is restricted to regulation relating to the MFI model.

As MFIs quickly scaled up in size and number, the way these institutions function and the

[1] Srinivasan, N. (2010). *State of the Sector Report*, ACCESS Financial Services.

[2] Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector, RBI, January, 2011.

[3] About Microfinance on NABARD website URL: www.nabard.org/microfinance/mf_institution.asp

potential harm that accompany their services came into question. Coercive collection practices, usurious interest rates, and use of selling practices that result in over-indebtedness for consumers are the primary customer complaints that led to a crisis. Current regulations in the sector do not address these issues, and hence official action cannot be taken, prolonging repayment issues, liquidity issues, and general uncertainty.

In Andhra Pradesh during the latter half of 2010, MFIs were accused of engaging in abusive practices that resulted in borrower suicides. State and local politicians encouraged non-repayment, and passed the Andhra Pradesh Microfinance Ordinance 2010,[4] which put additional constraints on MFI practices at the state level. The Andhra Pradesh Micro Finance Institutions (Regulations of Money Lending) Act 2010 replaced the Ordinance and also included a list of actions which constitute coercive action. The main features of the enactment are as follows:

a) every MFI has to register before the designated registering authority of the district
b) penalties for failure to register and for coercive acts of recovery
c) prohibition on use of agents for recovery or use coercive methods of recovery
d) all MFIs have to submit a monthly statement to the registering authority giving specified details
e) no member of an SHG can be a member of more than one SHG
f) no MFI can give a further loan to a SHG or its member without the approval of the registering authority where there is an outstanding bank loan.

As a result, funds stopped flowing to MFIs, resulting in a liquidity crisis in the sector. Since no clear regulation prohibits such acts from government and legislatures in other states, investors and banks reasoned that similar crises were possible across India. Thereafter, there were many calls for regulatory reform to address pending issues in the sector that led to this situation. It is pertinent to provide here the comparative findings of 'Global microscope[5] on the microfinance business environment' where the ranking of India on the index went up from 27 in 2011 to 22 in 2012.

A year after its formal launch, the Indian government has begun to roll out a mammoth new poverty reduction scheme—the National Rural Livelihoods Mission (NRLM). The programme is widely believed to increase unfair competition from subsidised public programmes in a market that has so far relied on a market-based arrangement. The plan's large mandate is to reach out to 70m households living below the poverty line in 600 districts covering 250,000 gram panchayats (local level self-government) by March 2018. Sector participants expect the NRLM programme to have a profound impact on the private provision of microfinance.

Successful experience of several large scale rural livelihood programmes, which formed the basis for NRLM, has created new clients in the microfinance sector. These programs have encouraged various financial institutions to work with SHGs to deepen and expand financial outreach, including savings, credit, insurance and pensions. By making financial literacy and financial planning a core aspect of institution building and increasing emphasis on savings and savings mobilization, the design of NRLM seeks to

[4] Andhra Pradesh Ordinance, 2010. URL: http://indiamicrofinance.com/wp-content/uploads/2010/10/Andhra-MFI-Ordinance.pdf

[5] Global microscope on the microfinance business environment 2012 report benchmarks the regulatory and operating conditions for microfinance in 55 developing countries globally. Commissioned and funded by MIF, CAF and IFC, Microscope 2012 is the Economist Intelligence Unit's fourth annual effort to assign ratings to microfinance markets in these 55 countries.

https://www.eiu.com/public/topical_report.aspx?campaignid=microscope2012

ensure that financial inclusion of the poor is achieved in a sustainable and responsible manner.

Since the start of 2012, the MF sector has begun to move beyond the AP crisis, which has severely impaired operations of most major MF providers. In December 2011, the RBI created a separate legal category for NBFC-MFIs for which it issued prudential and non-prudential norms and customer protection regulations. This latest regulation complements other post-AP regulations that introduced a quantitative definition of microfinance loans, a ceiling on loan amounts and number of loans per customer, interest rate caps and margin caps.

In May 2012, the cabinet approved a long-stalled microfinance bill. The draft bill still needs parliamentary approval to become law. It has been completely recast and, if adopted, will have a profound impact on the microfinance sector. It is seen as far superior to the 2007 version and reflects the lessons from the AP crisis. Crucially, the bill would supersede the AP Act, state legislation that effectively shut down microfinance in Andhra Pradesh, still prevents MFIs from collecting US$1bn-2bn in outstanding loans in the state, and restricts both MFI access to bank funding and access for the poor to credit and basic financial services.

The chapter gives an overview of the existing microfinance regulatory structure in India, and then identifies their limitations. There is a discussion on other countries to see how regulation has addressed similar limitations across the globe, and how these methods affect the local sector. It outlines the issues a microfinance regulation should consider, discusses the global best practice regulations and presents an analysis of the henceforth Microfinance Regulations Bill. Drawing from this analysis, the chapter concludes, with some recommendations for regulatory amendments.

2. The Microfinance Regulatory Structure in India - Overview and Limitations

Legal Structures of MFIs

A MFI in India acquires permission to lend through registration (Table 1 provides details of the registration requirements). MFIs are registered as one of the following five types of entities:[6]

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

NGO MFIs: There are around 500 NGOs that provide microfinance services and operate as non-profits, although many of these NGO MFIs perform non- financial operations as well. NGO MFIs can be registered as a Society under the Societies Registration Act of 1860 or as a Trust under the Indian Trust Act of 1882.

Cooperative Societies: Approximately 100 MFIs in India operate as Cooperatives, registered under the Cooperative Societies Act of the respective state, the Central Multi-State Cooperative Act, 1984, or the new state-level MACS Act. The MACS Act was pioneered by Andhra Pradesh, which sought to prevent political interference in cooperative societies' operations. Some large cooperatives have acquired a banking licence from the RBI to operate as cooperative banks.

Section 25 Companies: Many NGO MFIs achieve a more formal corporate structure by registering under the Companies Act, 1956, as a Section 25 Company. These companies offer a structure that can more easily transform into an NBFC. They can accept equity investments, though they cannot

[6] Status of Micro Finance in India 2009-2010, NABARD, www.nabard.org/pdf/Status%20of%20Micro%20Finance%202009-10%20Eng.pdf. For a detailed description of various legal forms we recommend Sa-dhan's 'Existing Legal and Regulatory Framework for the MFIs in India: Challenges and Implication'

offer dividends, and equity investments cannot be withdrawn at the closing of the company. Thus, these institutions often have difficulty attracting equity investments.

NBFCs: The mainstream financial sector in India is divided primarily into two categories, banks and NBFCs. Banks adhere to much more stringent regulation than NBFCs because they are all permitted to accept public deposits, and are considered to have consequent systemic risk. The NBFC encompasses many different types of financial companies, which are all subject to the same regulation requirements. Many MFIs have recently registered as NBFCs to take advantage of access to capital markets. NBFCs account for the great majority of the microfinance market in India, with about 50 NBFCs responsible for 80 per cent of all microfinance portfolios.

NBFC-MFIs: For-profit institutions that qualify for priority sector lending funds are registered as NBFC-MFIs. This NBFC sub-category was created by RBI in May 2011 to classify NBFCs operating as MFIs which meet certain requirements. Currently, it is unclear how many NBFCs will elect to register as NBFC-MFIs, and how many will continue to operate as NBFCs. At this point, only priority sector funding requirements have been made applicable for NBFC-MFIs, though it seems that all existing NBFC regulations also apply to NBFC-MFIs.

Current MFI Regulations

This is a very uncertain time for microfinance regulation, since there exist a significant amount of pending regulation. The Malegam Committee recommendations have been 'broadly accepted' by the RBI, though the specifics of the regulation have only been released for items relating to priority sector lending status. The draft of the Microfinance Regulations Bill 2011 has been released as well, and though the bill has been generally well received by practitioners and policymakers, its passage is still awaited.

As sectoral regulation stands now, all the legal structures listed in the previous section face minimal regulatory requirements, except for NBFCs and NBFC-MFIs. Annexure A tabulates the major regulations applicable to NBFCs as stipulated by the RBI. Major regulatory aspects discussed include priority sector lending, deposit mobilisation, access to capital, the Money Lending Act, and state level regulations.

Priority Sector Lending: Priority sector lending is a government initiative which requires banks to allocate a percentage of their portfolios to investment in specified priority sectors at concessional rates of interest. Currently only MFIs registered as NBFC-MFIs are designated as a priority sector. The number of priority sectors has recently been reduced, which suggests that banks will be relying more heavily on lending to MFIs to meet the priority sector requirements. In order to register as a NBFC-MFI, an institution must meet requirements specified by the RBI.

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

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

An NBFC-MFI must also adhere to the following pricing requirements:

- Margin cap of 12 per cent
- Interest rate cap of 26 per cent Only three

pricing components

- Interest rate
- Processing fee (maximum 1 per cent)
- Insurance premium
- No penalty for delayed payment
- No security deposit or margin can be taken

Banks are responsible for ensuring that the institutions receiving priority sector funds adhere to these requirements, with verification through a quarterly Chartered Accountant's Certificate. Securitised assets may also qualify as priority sector assets if an institution meets these requirements. It is assumed that NBFC-MFIs must also adhere to general NBFC requirements.

Deposit Mobilisation: Regulation stipulates that only NBFCs and Cooperatives are permitted to accept public deposits, though NBFCs must adhere to additional stringent regulations,[7] and Cooperatives are only permitted to accept deposits from its members. There also exists what is called a deposits limited for NBFCs linked to the institution's Net Owned Fund (NOF). No MFI registered as an NBFC currently accepts deposits because regulation requires that institutions must obtain an investment grade rating, which no MFI has obtained so far.

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

NBFCs can receive both equity and debt investments. NBFCs can raise foreign equity investment, though a minimum investment restriction requirement of US$500,000 applies, also with a cap of not more than 51 per cent stake in the institution. Grants and subsidised onward-lending funds from domestic and foreign sources are not restricted, provided that the foreign grants do not exceed the ceiling of US$5mn per year.

Section 25 companies have difficulty attracting equity investments because they are unable to offer dividends and exit opportunities are difficult to predict. They can access External Commercial Borrowing (ECB) up to US$5mn, though the amount that institutions will lend to a Section 25 company is dependent on existing equity. Due to this leverage restriction, many Section 25 company's end up borrowing significantly less than the US$5mn limit.

MFIs can also access priority sector lending funds. Banks are required to lend 32-40 per cent of their net credit to priority sectors identified by RBI at a rate lower than the prime lending rate. Microfinance businesses qualify for priority sector lending,[8] and can mobilise this capital much more freely than banks.

Money Lending Act: The Indian Moneylenders' Act 1918 has been adapted by various state governments to restrict interest rates charged by moneylenders. Although the primary purpose of this Act is to protect vulnerable section from the usurious interest rates that moneylenders charge, some states have applied the Act to Societies and Trusts to restrict their lending activity. Other states have applied the Money Lending Act to other forms of MFIs. Gujarat, for example, applied the Money Lending Act to NBFCs in early 2011. Different states have made different provisions while adapting the Act, often restricting interest rates and requiring licences for conducting a money lending business.

State Level Regulation: In late 2010, the Andhra Pradesh government enacted the Andhra Pradesh MFIs *(regulation of money lending)* Ordinance, which was later enacted into Act, to regulate the activities of MFIs. The

[7] Manual on Financial and Banking Statistics, Box6.2, Chapter VI, Reserve Bank of India, http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/78928.pdf

[8] Reserve Bank of India (2004). Master Circular on Priority Sector Lending, June.

Act stops MFIs from collecting old loans and originating new loans until the institution registers with the district authorities where they operate. The Act also mandates an interest rate cap such that the total interest charge cannot exceed the principal amount of the loan. The Act also entrusts a great deal of discretionary power to the registering authorities and imposes restrictions on collection practices.

In a perception survey carried out under this project, a semi-structured questionnaire-based survey of key stakeholders/experts in the sector was conducted, selected from the industry, academics/consultants and policy practitioners, through in-person interviews/meetings and telephonic Consultations. The interviewees were asked to rank, among other things, the regulatory impediments to competition and growth in the sector. The majority of stakeholders (68 per cent) were of the opinion that MFI sector in India needs to be regulated. To control the on-going problem of over-borrowing and unsustainable debt of MFIs (as MFIs in India give multiple loans to borrowers), majority of the respondents (63.7 per cent) in the perception survey suggested that the creditor should conduct an ability to pay test (the know your customer or KYC exercise) before extending multiple loans.

Competition Analysis

This section provides a brief analysis of competition assessment of the current regulations. Ensuring fair competition in markets is very important for the sector's development of a country like India. Yet the government policies, rules and regulations often pose a threat to fair competition. Anticompetitive practices and policies prevailing in both public and private sectors must be addressed to ensure fair competition. The objective of 'competition assessment' is to examine the potential harm/benefit that might be caused to competition by the rules and regulations laid down by regulatory agencies. Table 2 summarises the competition assessment of the microfinance sector in India:

Limitations of Current MFI Regulations

As evident from Table 2, an important limitation of current regulations is the lack of clarity on Central and state regulatory jurisdiction. During late 2010 and early 2011, following the early 2010 eruption of the microfinance loans related deaths and the resultant furore, both Andhra Pradesh and Gujarat passed legislation barring specific microfinance practices within the state, requiring specific consumer protection policies and capping interest rates. States currently have great discretionary power as to how to interpret the Money Lending Act. Stability and confidence will elude the sector until this regulatory ambiguity is resolved.

Lack of consumer protection regulation is another limitation of the current structure. There is no regulation that has resulted in a functioning redressal procedure for borrowers to provide feedback on improper collection practices and abusive lending techniques. More than 57 per cent of stakeholders in the perception survey agreed that the sector/consumers suffer because of the coercive practices and high interest rates charged by the creditors. Furthermore, standard regulation that explicitly defines appropriate customer protection rights and penalties for violations does not exist.

A major problem in the industry today is over-indebtedness of the customer. A functioning credit information system would be the best way for MFIs to predict a customer's ability to pay. There are several initiatives to start credit bureaus, and some existing microfinance credit bureaus are rapidly expanding their information base, however no regulation requires or incentivises institutions to submit information to credit bureaus.

Lack of diversification of funding is also problematic for MFIs due to current regulation on access to capital. Regulation allows NBFCs to raise capital from foreign equity investment, however the minimum investment is very high, and the minimum investment cannot account for more than 51 per cent of the company. This requirement excludes a large number of foreign investors

that may want to direct their funds to the sector. The restriction on ECB for NBFCs also greatly reduces funding options for MFIs.

Finally, the inability for MFIs to take deposits from the public is a missed opportunity for the sector. Accepting deposits is a service to both clients and institutions. Clients will have a more convenient way to accumulate funds, which will benefit them for emergency protection and saving purposes. Institutions accepting deposits will have a cheap source of funding, thus allowing for potentially lower costs for customers and extension of services to underserved areas. Regulation should allow for qualified institutions to accept public deposits while meeting strong prudential requirements.

3. Model Microfinance Regulations and Evaluation of the Microfinance Regulation Bill

Regulatory Issues that Microfinance sector needs addressed

Regulation of the financial sector is commonly divided into two categories: prudential and non-prudential. Regulation is prudential when it intends to protect the financial system from systemic risk, and to protect deposit safety. Prudential regulation by nature requires a regulator with sophisticated financial knowledge and experience, and one that is comfortable addressing issues such as capital adequacy, liquidity, reserves, and treatment of assets, in order to ensure the soundness of financial institutions. Non-prudential regulation addresses issues relating to the behaviour of financial institutions with respect to their conduct of business. These principles are equally applicable for the microfinance sector. For this analysis, selected prudential and non-prudential areas for regulation from a study conducted by the CGAP are relevant.

Prudential Regulations

Minimum Capital: There are often minimum capital requirements to attain normal bank licences to ensure that institutions have a base level of capital that will allow them to cover fixed costs. Investors and donors that support MFIs may not be able to contribute enough to attain a normal bank licence, thus these requirements may be adjusted to suit MFIs accordingly.

Capital Adequacy: Capital adequacy refers to the amount of capital that is held relative to the assets of the institution. The microfinance model differs greatly from traditional banking methods, so regulators must decide how much capital institutions should hold based on the unique challenges of the industry, such as high repayments but greater and unknown risks and shorter history of operation.

Loan Documentation: Requiring MFIs to follow the same loan documentation process as commercial banks would greatly burden institutions. Documentation requirements thus must strike a balance between useful and constraining, with regulation considering the lack of personal documents of borrowers, lack of financial statements for businesses, and structure of microfinance loans and repayments.

Non-Prudential Regulations

Permission to Lend: Sometimes lending is permitted because it is not explicitly outlawed. In such circumstances, an institution would have permission to originate and service microfinance loans. In other legal systems, a system cannot lend unless it is given permission to do so. Regulation directly or indirectly needs to address the institution's ability to lend.

Consumer Protection: The two primary consumer protection issues in microfinance that regulation should address are abusive lending and collection practices, and truth in lending. Abusive lending practice refers to abusive loan techniques, where the collector unfairly intimidates, harasses, threatens, or harms the customer. Abusive lending practice also applies to lenders which induce customer over-indebtedness, either intentionally or through lack of repayment assessment.

Truth in lending regulation relates to the transparency of products being provided by institutions. Often multiple fees and different interest rate computation methods make it

difficult for consumers to understand the risks of products, and to compare a product to other products, or similar products provided by other institutions.

Credit Reference Services: Often called credit bureaus, credit reference services collect financial information on clients' status and history and supply this information to institutions to improve risk analysis and mitigation. Regulation may create a credit bureau, or require participation from MFIs and merchants. Customer privacy must be made a priority, and a customer's access to his own information should be permitted to ensure data accuracy.

Interest Rate Limits: MFIs charge much higher interest rates than commercial banks, citing higher administrative costs, higher service costs, and greater risk. However, regulators at times set interest rate limits for loans. These limits can differ based on institution specifics such as size of the institution, registration of the institution, demographic the institution serves, and institution cost of funding.

The existing regulatory structure that applies to MFIs in India currently does not adequately address all of these points.

Global Best Practices

The microfinance sector has unique challenges, which are distinct from the challenges of the traditional consumer and commercial financial sectors. Microfinance services are often provided to people who do not have any collateral security to offer, and who may lack identifying documentation and credit history. Transaction costs are also much higher than the traditional sector, since agents need to meet customers at all hours and at unorthodox locations as they extend financial services to areas that previously had none. A country which implements successful microfinance regulation does not simply enforce existing financial regulation, but designs regulations factoring these unique challenges.

Microfinance practices and challenges also vary between countries. There is no one set of regulation that can be considered as an all-encompassing answer to the needs of the sector. Every country may confront similar issues, however how these issues are dealt with will vary, based on the financial environment and priorities and goals of the sector. Many countries have a substantial number of people without access to formal financial services, though microfinance models vary greatly. Further, many countries have formal microfinance programmes, though some countries have primarily non-profit institutions, some have a sector dominated by for-profit institutions, and some have government-led initiatives.

MFI models vary from country to country as well, even varying greatly within some countries. In the global best practice section, regulatory issues are examined that every country must address, and look to other examples around the world for successful regulatory implementation.

Prudential Regulations

Prudential regulation almost always only applies to MFIs that accept deposits, since MFIs are not large enough to pose systemic risk to the financial system of a country. Applying prudential regulation to institutions that do not take deposits results in unnecessary costs for both regulators and institutions.

Minimum Capital Requirement: Nearly all countries that enforce prudential regulations have a minimum capital requirement to ensure that institutions have capacity to cover the fixed costs associated with deposit taking, such as additional reporting and risk management required. Regulators also use the minimum capital requirement to roughly control the number of qualifying institutions.

Bolivia used the minimum capital requirement for MFIs well in this regard, initially requiring a relatively small minimum capital amount, and then increasing this amount as MFIs grew in size and maturity. Currently, Bolivia's minimum capital requirement is US$6mn, which is significantly higher than most countries with a less-developed microfinance sector. The minimum capital value is most often determined by a

regulator, the central bank, or legislators, depending on the country's preferences. The entity which controls the minimum capital requirement must set and adjust the amount according to the number of qualifying institutions and to keep par with economic measures, such as inflation and foreign currency rates.

Minimum capital requirements can differ within a country as well, as in Pakistan and Indonesia. Pakistan requires minimum capital based on whether the institution operates within a district, within a province, or nationwide, with different requirements for different districts and provinces.[9] Honduras bases minimum capital requirements on urban agglomeration. These approaches allow for more growth potential and privileges for MFIs that are serving underserved or rural areas.

Capital Adequacy: Capital adequacy requirements are used by nearly all countries to reduce the leverage and thus risk of MFIs that are subject to prudential regulation. The actual percentage of assets required varies amongst countries, though the requirement is almost always higher or equal to those of domestic commercial banks. Countries that have higher requirements often contend that microfinance banks have a shorter track record, and that microfinance portfolios are riskier than commercial bank portfolios. Common capital adequacy requirements in selected countries are shown in Table 3. It may be noted that exact definitions of terms must be examined for each country for a full understanding of the implications of the requirements and their impact.

In all the countries except Ethiopia, MFIs must hold at least the recommended 8 per cent capital. Uganda clearly has the tightest requirement with 15 per cent for core capital (the Basel Committee recommends 4 per cent for this) and 20 per cent for total capital. An interesting case is Nepal, which uses both a leverage ratio and a capital adequacy ratio. The aggregate amount of all deposits and advances from members of cooperative societies has been limited to ten times the amount of core capital.

Such a ratio does not rule out the possibility of increasing leverage by borrowing money, as it does not include debt. This ratio is a more crude measure than the capital adequacy ratio, as it does not use risk-weights to reflect the differences in risk associated with different kinds of assets. Indonesia's BPRs are subjected to a rather low CAR of 8 per cent. To give BPRs an incentive to hold more capital, a current proposal is to reward a higher CAR of, say, 12 to 15 per cent with a better overall soundness rating and permission to open new branches.[10]

Non-Prudential Regulations

Permission to Lend: Permission to lend is granted through registration in countries with more advanced regulatory frameworks. Many countries offer a special microfinance window for registration of MFIs, which allow regulation and legislation to be specific to these MFIs. Some countries offer multiple windows to allow for different types of institutions. Nepal has three windows which separate microfinance NGOs, cooperative societies, and development banks. Ghana's registration allows for nine different types of institutions, with several offering microfinance services. Each country will have a different approach, but best results have come when regulation is able to address the specific challenges associated with institutions offering microfinance services.

For lending business, some countries stipulate a maximum loan size, expressed as a percentage rate of capital or as an absolute amount. The two extreme cases are Ethiopia and Indonesia. Ethiopia's MFIs are only allowed to lend up to a fixed amount of US$600 to a single borrower, while the same

[9] Ahmed, S M and Shah, M (2007). Amendments to the MFI Ordinance, 2001, The Pakistan Microfinance Network.

[10] Staschen, S. (2003). *Regulatory Requirements for Microfinance: A Comparison of Legal Frameworks in 11 Countries Worldwide*, GTZ Division for Economic Development and Employment Promotion.

limit for Indonesia's BPRs is currently at 20 per cent of total capital (which is likely to be reduced in the future).

In addition, BI is considering placing an aggregate limit (on total capital or on total loans outstanding) for the largest borrowers. In some countries, the limit depends on the kind of security available. Honduras' FPDOs may grant loans of up to 2 per cent of equity capital if secured by a surety and up to 5 per cent of capital if secured by other means. In Ghana, rural banks can lend up to a limit of 25 per cent and 10 per cent of capital in the case of secured and unsecured loans respectively.

In Uganda, the loan size limit depends on whether the loan is granted to an individual (1 per cent of core capital) or to a group of borrowers (5 per cent). The rationale is that group loans are typically larger and that the regulatory framework should not favour one lending technology over the other.

Nepal allows for larger consecutive loans with the second loan being double the amount of the first, and the third and all following loans being again double the size of the second. Even though such a requirement takes the graduation principle of many MFIs into account, it might be difficult to control for the supervisor.

Finally, Pakistan limits the size of loans to a single borrower to a fixed amount of US$1,725 irrespective of the size of the microfinance institution/ bank.

Consumer Protection: Successful consumer protection regulation levels the information gap between institutions and consumers. Regulation must protect consumers and allow for innovation, while not imposing excessive costs. Regulators in several countries provide consumers adequate information and allow for consumer complaints to be heard and addressed. Cambodia, Peru, Ghana, and many countries in Eastern Europe and the former Soviet Union have recently implemented new price disclosure rules that strive to ensure these objectives.[11] Peru is an example of a country who has implemented a successful consumer protection policy. In Peru, the financial regulatory authority puts policies and procedures in place regarding how institutions receive, manage, and resolve consumer complaints. In 2008, approximately 99 per cent of 400,000 consumer complaints were handled by this financial regulatory authority. Consumers may also take their complaints to the courts, the banking association's financial ombudsman, or a consumer protection agency. Peru combines these opportunities with adequate supervision and financial literacy campaigns and projects. Off-site supervision of institutions assures that relevant and adequate information is disclosed. As a result of these policies, consumer complaints dropped by 32 per cent since 2004.[12]

Malaysia also focuses heavily on consumer education and response to consumer complaints. Financial information is disseminated to schools, community groups, and through various media sources to develop financial literacy. Financial institutions are required to have a complaints unit, with services targeting youth, involvement of the financial industry, credit counselling, and debt resolution. The central bank also receives complaints and offers advice.[13]

According to the CGAP Access to Finance Survey 2010,[14] Regulators most frequently

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[11] Brix, L. and McKee, K. (2010). *Consumer Protection Regulation in Low-Access Environments: Opportunities to Promote Responsible Finance*, CGAP Focus Note 60. Washington, DC: CGAP, February.

[12] Alliance for Financial Inclusion (2010). *Consumer Protection: Levelling the playing field in financial inclusion*.

[13] Conroy, J., Parrenas, J and Manupipatpong, W (2009). 'Promoting Financial Inclusion through Innovative Policies', Asian Development Bank Institute, April

[14] CGAP (2010). CGAP Access to Finance Survey, 'Financial Access 2010: The State of Financial Inclusion Through the Crisis', Washington, DC: CGAP and the World Bank Group

require countries to have plain-language, to provide documentation in the local language, describe recourse rights and processes. For deposit products, regulators can require that institutions provide annual percentage yield and interest rate, method of compounding, minimum balance requirements, fees and penalties, and early withdrawal penalties. For credit products, regulators can require that institutions provide an annual percentage rate using a standard formula, all applicable fees, computation methods, and required insurance.

Credit Reference Service: The great majority of countries believe that credit reference services would improve conditions for both customers and institutions. However, regulation will determine what is required for these bureaus. Some countries require financial institutions to submit customer information. Peru initially required submission of information on borrowers with loan amounts greater than US$5000, which excluded micro-loans. However, regulation was later amended so that customer information is required to be submitted for all loans. Thus, institutions can check for credit history when extending a micro-loan.

Interest Rate Caps: Interest rate caps, though intended to protect the poor, often results in a reduction of financial services to the poorest of the poor and to those in rural areas. The costs of making very small loans and servicing rural areas is greater than making larger loans and servicing more urban areas, thus when an interest rate cap is implemented, MFIs in many countries have reduced these services to maintain profitability. Interest rate caps can also result in less product transparency, since institutions may try to add charges or penalties that make it more difficult to understand product risk.[15]

When an interest rate cap of 27 per cent was implemented in South Africa, institutions immediately withdrew from rural areas and focused on less expensive areas to serve. Nicaragua's MFIs' portfolio annual growth fell to 2 per cent from 30 per cent when an interest rate cap was introduced in 2001.[16] An UK's Department of Trade and Industry policy paper[17] shows that even in a developed country like the US, interest rate caps restrict the diversity of products offered and the ability of lenders to offer products to different segments. Table 4 shows the interest rate changes, and the implications for microfinance loans as well as loans in selected countries.

The Micro Finance Institutions (Development and Regulations) Bill, 2011

It is in the above light of limitations of current regulations, the desired regulatory interventions and lessons from a cross-country evaluation of MFI regulation practices that the Microfinance Regulations Bill, 2011[18] is evaluated. This Bill is an updated version of an earlier 2007 Bill. The Bill has been re-drafted several times, with the most recent draft released in July 2011 incorporating the most recent RBI regulation. The Bill aims "to provide access to financial services for the rural and urban poor and certain disadvantaged sections of the people by promoting the growth and development of MFIs as extended arms of the banks and financial institutions and for the regulation of micro finance institutions and for matters connected therewith and incidental thereto".

The Bill acknowledges that the microfinance sector lacks a formal statutory framework for its financial activities, and that it is expedient to provide a formal statutory framework for the promotion, development, regulation and orderly growth of the micro finance sector and thereby to facilitate universal access to integrated financial services for the un-

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[15] Helms, B., and Reille, X. (2004). 'Interest Rate Ceilings and Microfinance: The Story So Far', CGAP Occasional Paper 9, September

[16] CGAP (2004). *The Impact of Interest Rate Ceilings on Microfinance*, May

[17] UK's Department of Trade and Industry, Policies, 2004.

[18] Micro Finance Institutions (Development and Regulations) Bill, 2011 URL: http://finmin.nic.in/the_ministry/dept_fin_services/micro_finance_institution_bill_2011.pdf

banked population. The Bill encompasses all legal forms of MFIs, providing a comprehensive legislation for the sector. The Bill includes:

- Designation of RBI as the sole regulator for all MFIs Power to regulate interest rate caps, margin caps, and prudential norms
- All MFIs must register with RBI
- Formation of a Micro Finance Development Council, which will advise the Central government on a variety of issues relating to microfinance
- Formation of State Advisory Councils to oversee microfinance at the state level
- Creation of Micro Finance Development Fund for investment, training, capacity building, and other expenditures as determined by RBI

It has been argued[19] that in its new avatar, the Microfinance Regulations Bill appears to be a comprehensive piece of central legislation that aims to resolve the long standing challenges that the microfinance sector has faced.

The Bill establishes: (a) the supremacy of RBI as the key regulator for the microfinance sector by clearly treating microfinance as an extension of banking services (by indicating a departure from treating microfinance as credit-alone business and through this clearly making a distinction between microfinance industry and money lenders, the latter are controlled by state regulations); (b) introduces measures for consumer protection and grievance redressal by introducing obligations and putting in place extensive monitoring and reporting requirements (additionally the Bill gives RBI the power to recognise the Code of Conduct for MFIs through a self-regulatory organisation and a client protection code); and (c) ensures that microfinance as a business must have limits to profitability and while scale is important the investors must not make disproportionate profits, by retaining two key recommendations of the Malegam committee on capping the interest rate and putting in place margin caps.

In the last, however, an inadvertent fallout could be that an artificial limit (on interest rates) is in place as the benchmark for performance and the margin cap may limit incentives for the MFIs to rework their cost structures and use technology to bring down their costs once they have reached a certain benchmark.

The chief features of the Bill are that every institution in microfinance should register with the regulator, transform into a company when they attain a significant size, be subject to a variety of prudential and operational guidelines that are introduced by the regulator, provide periodic information to the regulator and face penal action for violation of law or any rules framed. The Bill provides flexibility of RBI to apply different measures, vary the same and delegate the powers of regulation to NABARD.

The designation of RBI as the sole regulator is a positive step forward for the sector. Though the specifics of regulation are yet to be determined, having one respected regulatory who is acknowledged as in charge of all aspects of the sector would lead to a great reduction of regulatory uncertainty. If the bill passes, a greater challenge will remain; RBI must effectively regulate and monitor a great number of MFIs that have previously been subject to very little regulation.

4. Conclusion and Recommendations

Clearly, the current regulatory structure requires reforms, and the Microfinance Regulations Bill seems to meet most of the requirements as can be identified from the cross-country analysis of best practices. An ideal regulation should require registration for all MFIs, encourage extension of services to under-served populations through priority sector lending qualification, clarify state and central regulatory jurisdiction, require

[19] See analysis and discussions at: http://microfinance.cgap.org/2011/07/24/india%E2%80%99s-microfinance-bill-answers-most-questions/ and http://microfinance.cgap.org/2011/08/04/india%E2%80%99s-microfinance-bill-offers-a- mixed-bag-to-investors/

institutions to submit information to a credit reference service, address consumer protection issues, enable qualified MFIs to accept deposits, and encourage diversification of funding for institutions. Clearly, addressing these issues will allow MFIs to expand financial services to more clients, and to protect more vulnerable clients from potential unethical behaviour. It would also help reduce the risk of political backlash and repayment crises.

Regulatory Recommendations

After reviewing the principles of regulation, the current regulatory structure, and global best practice, a series of regulatory recommendations have been developed that address the most pressing issues in the sector. These recommendations address institution registration and structure, priority sector lending, state vs. central regulation, the need for a credit reference service, consumer protection standards and implementation, interest rate caps, deposit collection, and diversification of funding for institutions.

Registration and Structure: The Bill rightly requires mandatory registration for all institutions that are providing microfinance services, irrespective of their legal structure, to ensure regulatory oversight and supervision. However, the current NBFC minimum capital amount (₹2 crore) should not be significantly increased so that for-profit MFIs do not face an overwhelming barrier to entry. For MFIs registered under other legal structures, a small minimum capital requirement and easier documentation is required to ensure that institutions can meet regulatory reporting requirements also.

Once registered, the institutions could be asked to follow uniform disclosure reports, which present minimal basic information to RBI. This registration process will be essential for enacting other types of regulation, such as credit reference service reporting requirements, consumer protection requirements, and qualification for priority sector lending.

Priority Sector Lending: Regulators should use priority sector lending funds as a tool to incentivise MFIs to serve underserved areas and income levels. For micro credit, assets qualifying for priority sector lending could be identified by district or region. MFIs that serve districts with lower financial services penetration could qualify for more priority sector funds. Additional requirements for these assets will be needed to ensure that this funding is directed towards services to the poor and underserved population. Qualifications could be determined regardless of geographic location as well, to invent institutions to serve the poorest of the poor.

State vs. Central Jurisdiction: Regulatory uncertainty is primarily caused by a lack of clarity on what is state jurisdiction and what is central jurisdiction. RBI must clarify the extent of its jurisdiction so that issues can be dealt with fairly and expeditiously by the appropriate advisory body.

Credit Reference Service: Though a credit bureau takes time, great energy and expenditure to develop, the sector should act now so that resources are available in the near future. Sharing loan information amongst participating institutions is a primary measure to ensure responsible lending. A few primary private credit bureaus should be selected to be the central repository for all microfinance services. Within six months, regulation should require that customer information is reported to credit bureaus, so that information can be accumulated for future use. This credit bureau should eventually collect both negative and positive information on borrowers from banks, retail outlets, and MFIs. Once a functioning credit bureau is in place that represents a significant portion of the population, regulation should require institutions to check a customer's information when he is applying for a loan. The implementation of the credit bureau will be the best protection against consumer over-indebtedness.

Consumer Protection: RBI must outline more specific definitions of coercive collection practices, adequate product transparency,

and abusive selling practices. While proposals of the Bill are being put in place, a good short- term solution is to entrust industry associations (such as Sa-dhan, MFIN) with enforcement of uniform consumer protection standards for their member MFIs. This enforcement will come in the form of code of conduct development, employee training review, and random checks at offices and field sites. The associations should send periodic information regarding the institution's consumer protection compliance to regulators, who could then determine if an institution is eligible for certain privileges, such as priority sector funds or permission to lend.

Also, the existing framework established by the Consumer Protection Act (COPRA) could be improved so that microfinance clients can overcome legal expenses and lender-small borrower relationship obstacles. This could be done by holding court proceedings at a local level, and sending legislative representatives to villages regularly to gauge MFI conduct.[20]

Interest Rate Cap: Implementing an effective and appropriate interest rate cap would be very challenging for a regulator. Other than discouraging performance improvements and use of technology as the MFIs near the performance benchmarks, using a universal cap could be detrimental for the sector, since it would most likely result in exclusion of financial services in various areas and populations where returns would not justify the operating costs. An interest rate cap should take into account various factors that typically affect the cost of operation, such as area of operation, average loan amount, legal form, and size of the MFI. An interest rate cap that accurately captures these factors would be nearly impossible to implement in India, thus it is recommended that the sector should continue without an interest rate restriction.

Deposit Collection: Both MFIs and customers would benefit if qualifying institutions were able to offer savings products. The Microfinance Regulations Bill identifies that MFIs are extended arms of the banks and that "Micro finance services" means one or more of the following financial services involving small amounts to individuals or groups: (i) providing micro credit; (ii) collection of thrift; (iii) remittance of funds; (iv) providing pension or insurance services; and (v) any other services as may be specified.

One way to accomplish this is to allow MFIs (specifically NBFCs, which are subject to prudential lending requirements) to qualify for deposit-taking by attaining a rating through selected rating agencies that specialise in microfinance.[21] Such rating agencies have a better understanding of the microfinance model, and the specific challenges and risks associated with this model. The amount of deposit collection permitted could be linked to the rating, or to the capital of the institution.

Diversification of Funding: MFI funding is primarily acquired through commercial lending from domestic banks. But regulation should promote the diversification of funding sources to encourage equity and foreign debt investments. With an unambiguous regulatory structure going forward, other investors will also come forward to invest, thus reducing sources of funding and overall amount of funding, particularly in times of crisis.

The minimum foreign equity investment amount should also be lowered to allow for equity investment possibility for smaller institutions. If this amount is reduced, a whole new set of investors will be able to access the market, thus increasing diversification of capital. NBFCs should also be permitted to access External Commercial

[20] Sane, R. and Thomas, S. (2011). 'The Role of Government in India's Microfinance Industry, IGIDR Working Paper 7, March. URL: www.igidr.ac.in/pdf/publication/WP-2011-007.pdf

[21] MCRIL (2011). *A Financial Inclusion Approach to Microfinance Regulation*. URL: www.m-cril.com/BackEnd/ModulesFiles/Publication/M-CRIL's-Supplementary-on-the-Malegam-Committee-Report.pdf

Borrowing.

In conclusion, microfinance is a service that aims to address the financial needs of under-served clients. Regulation and institutions should both focus on providing these clients with easily accessible financial services that cater to the specific needs and challenges that these clients face. A clear well- thought out regulatory structure is the best way to achieve India's goals of financial inclusion.

We agree that the new regulation is necessary for MFIs and should be expeditiously implemented; however, we do not see the need for a complete regulatory overhaul. The system has functioned well, allowing MFIs to prosper and grow to serve many more customers. The new regulation, should therefore, resist the temptation to overhaul the entirety of microfinance regulation, and should only make changes where current regulation is lacking.

Table 1: MFIs by Type of Registration

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

Source: M-CRILMicrofinanceReview2010, www.m-cril.com/Backend/ModulesFiles/NewsEvents/M-CRIL-Microfinance-Review-Nov2010.pdf

Table 2: Competitive Analysis

Factors Impeding Effective Competition	Present Status
1. Barriers to Entry	A company must have ₹2 crores Net Owned Funds (NOF), which is equal to shareholder equity plus internally-generated reserves, to register as an NBFC under the Company Act of 1856. These requirements are an obstacle for smaller institutions that may want to transform to a structure to more easily access capital markets. However, the minimum NOF is not unreasonable, and is necessary to control the number of qualifying NBFCs.
2. Limiting Product Scope	Regulation greatly restricts the type of products that can be offered, particularly relating to deposits. To be able to accept deposits, an NBFC must obtain a specified minimum credit rating (FA from CRISIL, MA from ICRA, BBB from CARE, tA from FITCH), minimum capital adequacy ratio of 15 per cent, and two years of completed operations. For qualifying institutions, additional ceiling limits exist based on credit rating. Furthermore, the period of a deposit, payable interest rates, brokerage incentives, and demand deposits are all strictly regulated. Section 25 MFIs are not permitted to take deposits. Due to these restrictions, no MFIs are currently mobilising public deposits. This regulation also restricts other product offerings where MFIs have outstanding obligations to customers, such as insurance or pension products.
3. Barriers to raising finances	RBI's Foreign Investment Promotion Board (FIPB) has set foreign direct investment (FDI) rules for start-up companies not traded publicly on a stock exchange, which includes NBFCs: • For FDI up to 51 per cent, minimum initial capitalisation of US$0.5mn • For FDI 51 percent-75 per cent, minimum initial capitalisation of US$5mn • For FDI 51 percent-75 per cent, minimum initial capitalisation of US$7.5mn and capitalisation of US$50mn within 24 months • FDI above 75 per cent is allowed for companies with capitalisation greater than US$50mn These restrictions greatly affect investment opportunities for medium and smaller MFIs, which may not be able to attract such large investments.
4.State Government Intervention	Currently, state governments can intervene and enforce additional regulation on MFIs regarding permissible products, methods of collection, and code of conduct. A lack of nation-wide regulatory structure makes the MFI's expansion into multiple states difficult to manage, and much less transparent. A case in point is the recent Andhra Pradesh MFIs Act, 2010. This Act requires all MFIs to register with the Andhra Pradesh government, and subjects them to a number of additional regulations specific only to Andhra Pradesh.
5.Product Transparency	Currently, there are no uniform product transparency requirements that would make institutions provide essential financial information, such as effective interest rate or

	possible future fees. Product transparency is essential to ensuring fair competition. A customer must be able to access information regarding product benefits and risks, so that institutions' offerings can be compared.
6. Priority Sector Lending	Only select institutions which meet a number of regulatory requirements qualify for priority sector lending. Companies that wish to provide products and services outside the scope of these (narrow) requirements do not qualify for priority sector lending, and thus face significantly higher financing costs.
7. NBFC Status	Many institutions operate as NBFCs for financial and regulatory benefits; however these licences are greatly restricted by RBI. The licences are notably difficult to obtain, even if all requirements are met, and many companies end up opting for NBFC status just for the privilege of operating as an NBFC.

Table 3: Capital Adequacy Requirements - A Cross-country Comparison

Country	Risk Weighted Capital Adequacy Ratio for Type of Institution	Remarks
Bolivia	8 per cent for Private Financial Fund; From 10 per cent for Open Savings and Loan Cooperatives to 20 per cent in (CAC) Category 1 to 4	Net equity as per cent of risk- weighted total assets and contingencies
Ethiopia	12 per cent for Micro Financing Institutions	Minimum capital adequacy ratio; applicable to re-registered MFIs
Ghana	6 per cent for Rural Bank; 10 per cent for Deposit-taking NBFI	Primary and secondary capital to adjusted asset base Supplementary and core capital to risk weighted asset
Indonesia	8 per cent for BPR	Primary capital and supplementary capital, with the latter not being larger than the former
Nepal	5 per cent for Cooperative Society; 10 per cent for Limited Banking	For core capital and total capital, Licence
Pakistan	15 per cent for Institutions providing MF services under MFI Ordinance	Equity (paid-up capital, share premium, reserves and unappropriated profits) to risk weighted assets
Uganda	15 per cent for Micro Deposit-Taking Institution	For core capital and total capital, respectively

Source: Staschen, S. (2003). Regulatory Requirements for Microfinance, GTZ.

Table 4: Interest Rate Caps in Select Countries

Jurisdiction	Date	Nature of Change	Reason for change and implication
Columbia	2006 (effective 2007)	Ceiling (34 per cent) for microloans higher than the general ceiling	Higher ceiling to encourage microcredit. Implementation of the new ceiling has not occurred, microfinance portfolios and institutions still expanding.[20]
Japan	2006 (effective 2009)	Lowers maximum rate to 20 per cent for consumer lending	Has already caused major changes in the consumer credit sector, including consolidation and failures of smaller lenders.
West Africa	1990s	27 per cent ceiling	MFIs immediately pulled out of rural areas, and increased average loan size. Eventually found ways to circumvent with fees.
Nicaragua	2001	The Central Bank publishes interest rates every month	Growth decreased to 2 per cent annually to 30 per cent annually. Several MFIs pulled out of rural areas.

Annexure A: NBFC Regulation

Parameter	Provisions
Capital adequacy	• NBFC having net owned fund exceeding ₹100 cores and not accepting public deposit is required to maintain a capital adequacy* ratio of 15 per cent • Any NBFC accepting public deposits needs to maintain capital adequacy* ratio of 15 per cent • No capital adequacy requirements for NBFC with net owned fund less than ₹100 crore and not receiving public deposit. *Note: Eligible capital consists of Tier I and Tier II Capital with the total of Tier II Capital not more than 100 per cent of Tier I capital.
Prohibition on loans	• NBFC is prohibited from lending against its own shares • NBFC that has defaulted on deposit obligations is prohibited from lending
Restrictions on investments	NBFC that accepts public deposits can invest a maximum of 10 per cent of its NOF in land and building (except for its own use), and 20 per cent of its NOF in unquoted shares of companies other than subsidiaries and companies in the same group.
Ceiling on concentration of credit/investments	• Maximum 15 per cent of NOF may be lent to a single borrower • Maximum 25 per cent of NOF may be lent to a single group of borrowers • Maximum 15 per cent of NOF invested in shares of a single company • Maximum 25 per cent of NOF invested in shares of a single group of companies
Accounting requirements	The NBFCs have to comply mainly with the following accounting requirements • Income recognition • Income from investments • Accounting standards • Asset classification • Provisioning requirements • Disclosure in the balance sheet
Audit committees	NBFC having assets of ₹50 crore and above as per the last audited balance sheet shall constitute an Audit Committee, consisting of not less than three members of its Board of Directors
Exposure to Capital Market	NBFC holding public deposits of ₹50 crore and above shall submit a quarterly return within one month of expiry of the relative quarter in prescribed format (Format NBS-6) to the Regional Office of the Department of Non-Banking Supervision of the RBI.

Annex B: The Malegam Committee Recommendations

Categorisation	Recommendations	Drawbacks
Qualify for Priority Sector Lending	• Customer household annual income does not exceed ₹50,000 • Loans do not have collateral backing • Maximum loan of ₹25,000 • Minimum 75 per cent of NBFC-MFI loans must be for income generating purpose	• Creation of "NBFC-MFI" sub-category unnecessary • Narrowly defines who needs microfinance services • Restricts competition from institutions that do not meet all requirements
Over-Indebtedness	• Total indebtedness limit of ₹25,000 per household • MFIs can only lend to members of a Joint Liability Group (JLG) • A borrower cannot be a member of more than one SHG/JLG • Not more than two MFIs can lend to one borrower	• Overall reduction of credit • Reduces customer's ability to manage own financial situation
Credit Pricing	• Only interest, processing fee, and insurance premium charges permitted • Margin interest rate cap of 10-12 per cent over cost of capital, depending on the size of institution • Maximum interest rate cap of 24 per cent	• Will result in less credit for poorer borrowers and customers in rural areas • Restricts product innovation
Product Restrictions	• Minimum period of moratorium between granting of the loan and commencement of repayment • The tenor of the loan is not less than 12 months where the loan amount does not exceed ₹15,000 and 24 months in other cases • The loan is repayable by weekly, fortnightly, or monthly instalments at the choice of borrowers	• Results in fewer consumer options • Reduces product innovation
Documentation	• MFIs must provide borrower a loan card which shows the effective rate of interest, other terms and conditions to the loan, information which adequately identifies the borrower, and acknowledgements of payments received • Effective rate of interest must be displayed in all offices, all literature, and on website • Standard loan agreement	• Potentially burdens loan process

About CIRC

Established in September 2005 with mission: To be a Centre of excellence on Regulatory Issues, CUTS Institute for Regulation & Competition (CIRC) is an esteemed institution, which primarily focuses on three areas, such as infrastructure, economic regulation and competition policy and law, and commercial & economic diplomacy with an objective of reaching out to the target audience in India and other countries of the developing world in Asia and Africa. Its crucial role in research and capacity building in the area of competition policy and law has created an intellectual knowledge base on regulatory reforms. This rich experience of working on competition policy and law has resulted in many national and international publications which have enriched a more informed discourse on public policies and greatly benefited different stakeholders in the society.

Since its inception, CIRC has been engaged with several training seminars and public lectures on the competition policy and law in India and abroad. It also organized international symposia on the political economy of competition and regulation in the developing world and India. The research outputs are used for providing specialized capacity building solutions to the stakeholders.