

Legislative Brief

The Micro Finance Institutions (Development and Regulation) Bill, 2012

The Bill was introduced in the Lok Sabha by the Minister of Finance on May 22, 2012.

The Bill was referred to the Standing Committee on Finance (Chairperson: Shri Yashwant Sinha) on May 28, 2012. The Committee was due to submit its report in August 2012.

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Highlights of the Bill

- ◆ The Bill seeks to provide a statutory framework to regulate and develop the micro finance industry.
- ◆ The Reserve Bank of India (RBI) shall regulate the micro finance sector; it may set an upper limit on the lending rate and margins of Micro Finance Institutions (MFIs).
- ◆ MFIs are defined as organisations providing micro credit facilities up to Rs 5 lakh, thrift collection services, pension or insurance services, or remittance services.
- ◆ The Bill provides for the creation of councils and committees at central, state and district level to monitor the sector.
- ◆ The Bill provides for a Micro Finance Development Fund managed by RBI; proceeds from this fund can be used for loans, refinance or investment to MFIs.
- ◆ The Bill requires the RBI to create a grievance redressal mechanism.

Key Issues and Analysis

- ◆ The Bill provides safeguards against misuse of market dominance by MFIs to charge excessive rates. It allows RBI to set upper limits on lending rates and margins. However, there is no provision for consultation with the Competition Commission of India.
- ◆ The Bill allows MFIs to accept deposits. Unlike banks, there is no facility for insuring customer deposits against default by MFIs. The minimum capital requirement is also lower, though RBI may prescribe higher requirements.
- ◆ The Development Fund for MFIs is to be managed by the RBI. The Bill also enables regulatory powers to be delegated to NABARD. Both these provisions could lead to conflict of interest.
- ◆ The Bill provides for the creation of micro finance committees at central, state and district levels to oversee the sector. However, the formations of these committees are not mandatory.
- ◆ The Bill allows MFIs to provide pension and insurance services. However, it does not provide for regulation by or coordination of RBI with the respective sector regulators.

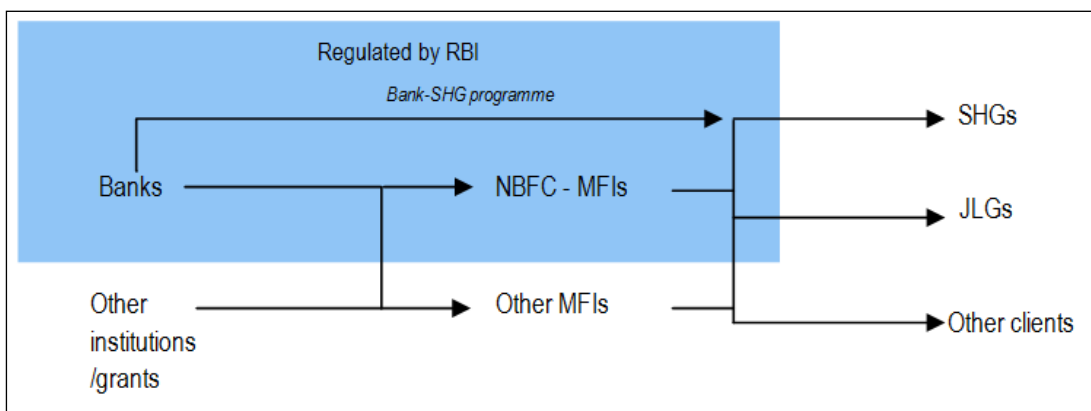
PART A: HIGHLIGHTS OF THE BILL¹

Context

Micro finance is the extension of financial services, notably small loans, to low income groups. It can serve as a vehicle for financial inclusion. Regular banks tend not to lend to the poor because of the high cost per individual loan and lack of collateral. In India, micro finance overcomes these issues by lending to Self Help Groups* (SHGs), i.e., groups of pooled borrowings, and Joint Liability Groups (JLGs)[†], i.e., groups of pooled liability. Delivery largely takes place through two mechanisms: the National Bank for Agriculture and Rural Development (NABARD) sponsored SHG Bank Linkage programme, where banks lend directly to SHGs and through micro finance institutions (MFIs) lending to SHGs, JLGs, rural banks and individual clients. Taken together, the Banks-SHG programme and MFIs reached 76.7 million people in 2010-11, a 71% growth over 2006-07.²

MFIs exist in various forms such as societies, trusts, co-operatives and non banking financial companies (NBFCs). In terms of market share, NBFCs dominate the industry, accounting for an estimated 90% of loan volume in 2010-11.² NBFC-MFIs are regulated by the Reserve Bank of India (RBI) Act, 1934. There is no statute regulating the rest of the microfinance industry consisting of societies, trusts and co-operatives.

Figure 1: Current flow of credit and regulation in Indian micro finance



Sources: RBI; NABARD; PRS

In order to regulate the sector, the government introduced the Micro Financial Sector (Development and Regulation) Bill, 2007, which designated NABARD as the regulator. This Bill lapsed with the dissolution of the 14th Lok Sabha. In 2010, following allegations of aggressive debt-recovery methods by MFIs, the Andhra Pradesh government passed an Act regulating MFI activity in the state. Following this, the RBI appointed the Malegam Committee to study issues and concerns in the sector.³ Based on the recommendations of the committee, RBI created a separate category of NBFCs (NBFC – MFIs) in December, 2011. All NBFCs providing micro finance services come under RBI’s regulations. The Committee also recommended introducing legislation to regulate the sector (See Appendix on page 5 for a summary of the Malegam Committee’s recommendations). In May 2012, the Micro Finance Institutions (Development and Regulation) Bill was introduced in the Lok Sabha.

Key Features

The Bill establishes the RBI as the regulator for all entities providing micro finance services.

Definitions

- The Bill defines MFIs as organisations engaged in providing micro finance services. These organisations could include a society, company or a trust, whose object is to provide micro finance services. The Bill specifically excludes: banking companies, co-operative societies engaged in agriculture or industrial activity and any moneylender (including those registered under state laws).
- Micro finance services are defined as micro-credit facilities not exceeding Rs 5 lakh; this can be exceeded (up to Rs 10 lakh) for purposes specified by the RBI. MFIs can also collect thrift (small deposits other than current accounts or demand deposits); provide pension and insurance services; and engage in remittance services.

* Banks/MFIs lend to SHGs as a whole. Individual members can contribute to and borrow from SHGs.

[†] In JLGs, member contributions are pooled to form the liability for individual members to borrow from banks or MFIs directly.

- The RBI is empowered to issue directions about the classification of a micro finance institution based on the deployment of assets and proportion of clients.

Registering Micro Finance Institutions

- The Bill requires any institution providing micro finance services to register with the RBI. The RBI should be certain that the institution will engage in providing micro finance services and have a net-owned fund (aggregate of paid up capital and reserves) of at least Rs 5 lakh.
- All organisations providing micro finance services will have to register within three months of the Act's commencement. Existing organisations registered with the RBI as an NBFC may continue to engage in micro finance activities subject to the rules and regulations issued by the RBI.
- Certificates of registration may be cancelled by the RBI if MFIs cease to provide micro finance services or fail to comply with any condition imposed by the RBI. MFIs can appeal to the central government against any rejection or cancellation of certificate.

Functioning of MFIs

- Registered MFIs will have to create a reserve fund containing an RBI-specified percentage of net profit or surplus. The fund can only be used for purposes specified by the RBI. NBFCs registered with the RBI are not obliged to create this reserve fund.
- The RBI can set a maximum limit on the interest rate an MFI can charge for micro credit facilities and the margin an MFI can make. In addition, the RBI can set a ceiling on the amount of loans given to clients and the number of individual clients an MFI has. The RBI can specify the tenure of micro credit facilities and other terms and conditions like periodicity of repayment schedules. MFIs will have to provide a breakdown of interest rates, processing fees or other charges on the loan document.
- For deposit acceptance, the RBI can provide directions relating to prudential norms like capital adequacy based on risk weights, accounting standards and deployment of funds.
- Any MFI restructuring, amalgamation or closure will have to be approved by the RBI.

Micro Finance Development Fund

- The RBI will create a Micro Finance Development Fund comprising of government grants, sums raised by donors and the public and any interest made out of investments. The Fund shall be used to provide loans, refinance, grant seed capital or any other micro credit facilities to any MFI. The fund can also be used to invest in existing MFIs.

Micro Finance Councils and Committees

- District Micro Finance Committees may be formed by the RBI and would be responsible for overseeing micro finance activities at the district level, including monitoring over indebtedness and methods of recovery and submit quarterly reports to the RBI.
- State Micro Finance Councils may be created by the central government to coordinate activities of the District Committees. The Councils will oversee micro finance activities of the state including methods of recovery and indebtedness. Each State Micro Finance Council would be required to prepare a quarterly report for the central government.
- At the national level, the Micro Finance Development Council can be constituted by the central government and would have an advisory role regarding the formulation of policies and measures. The council shall also create a credit information bureau for MFIs to store data about clients and loans.

Customer Protection

- The Bill requires the RBI to create a grievance redressal mechanism for MFI clients. The scheme should provide for the nature of grievance and procedure for redressal of these grievances and complaints.
- The RBI shall specify performance standards for methods of operation, methods of recovery and governance. In addition, the RBI will be responsible for promoting customer education of MFIs for greater awareness.

Offences and Penalties

- If an offence is committed, both the person responsible and the MFI will be guilty. Contravening provisions of the Bill or default can result in a prison term not exceeding two years or a fine of up to Rs 5 lakh.

Exemptions

- The central government, in public interest, can exempt certain classes of MFIs from the provisions of the Bill.

PART B: KEY ISSUES AND ANALYSIS

Interest Rates

Clause 24 (2)
(c)

The interest rates charged by MFIs for loans are usually much higher than the rates charged by banks. This is because the cost structures of MFIs are higher than that of banks on two counts. Firstly, funding for MFIs is costlier; for example in 2009-10 the average cost of funds for MFIs was 9.3% (of the loan portfolio)⁴ while for banks the equivalent figure was 5.1%.⁵ Secondly, MFI loans are smaller; individual loans typically range between Rs 10,000 and Rs 15,000.³ Consequently, the transaction cost as a percentage of the loan is higher for MFIs. In 2009-10, operating costs, which include administrative and personnel costs, was 12.3% of the amount lent for MFIs, while the equivalent figure for banks was 1.8%.^{4,5}

In order to prevent MFIs from charging excessive interest rates, the Bill enables RBI to set a limit on the interest rate and the margin (the difference between interest rates and cost of funds). In addition, RBI can specify the number of loans, size of loans and number of clients. Currently, the RBI has capped the margin at 10% for large NBFC MFIs (and 12% for the rest).⁶

The provision allowing RBI to set a cap on interest rates is designed to address an issue that arises from limited competition. In micro finance, the price of the product is the lending rate charged by an MFI. Price ceilings are introduced to prevent a monopoly or dominant power in the market from setting too high a price; an issue that comes under the purview of the Competition Commission of India (CCI). However, the Bill does not include any provision for RBI to consult the CCI when setting interest rates.

Depositor Protection

Clauses 25
(2) (m) and
18

The Bill permits MFIs to accept deposits. This would create an additional source of funding for MFIs, and also enable clients to have an option to save. However, depositor clients will bear the risk of default by an MFI, unlike borrower clients. Currently, banks and certain types of NBFCs can accept deposits and both are regulated by the RBI (see Table 1). The Bill empowers the RBI to issue directions to MFIs on prudential norms such as income recognition, accounting standards and capital adequacy.

Table 1: Key current prudential norms

	Banks	Public deposit accepting NBFCs
Net owned fund	Rs 300 crore	Rs 2 crore
Capital adequacy ratio	Min. 9%	Min. 15%
Transfer to reserve fund	None	20% of profits
Period of deposit	No limit	1-5 years

Source: RBI; PRS

Deposit Insurance

The possibility of a financial institution defaulting and unable to repay deposits poses a significant risk to clients. Deposits in banks are protected, up to Rs 1 lakh, through the Deposit Insurance and Credit Guarantee Corporation. The Bill does not explicitly set out a similar provision for MFIs. Although the Bill requires MFIs to create a reserve fund which could potentially serve as protection for depositors, contributions to this fund are a percentage of profits or surplus. Consequently, any loss-making MFI would not have a fund, leaving depositors without a safety net.

Capital Requirement

Clause
15(1)(c)

While the Bill gives RBI the authority to set prudential norms, it specifically lays out the requirement for a minimum net-owned fund of Rs 5 lakh for MFIs. It is not clear whether RBI will specify a higher net-owned fund requirement for deposit taking MFIs. In comparison, banks require a net owned fund of Rs 300 crore while public-deposit accepting NBFCs require Rs 2 crore.

Borrower Protection

Clauses 25
(2)(i) and
33

One of the major issues arising from the micro finance crisis in Andhra Pradesh was the method of debt-recovery; it was felt to be too aggressive and forceful. According to the Malegam Committee, methods of debt recovery are the responsibility of MFIs and every MFI should establish a proper grievance redressal procedure.³ The Bill provides for RBI to specify guidelines for fair and reasonable methods of recovery, but does not specify what this would entail. RBI has the power to issue directions to MFIs about observing codes of conduct and setting up MFI-specific grievance redressal mechanisms. In addition, it will also issue a code of conduct for field staff, laying out minimum qualifications and training tools.

Currently the RBI has provided an NBFC Fair Practices Code⁷ which issues directions on fair practices to NBFCs and in particular, NBFC-MFIs. With regard to debt-recovery, the RBI has specified that recovery should be made at a designated central place and recovery at place of residence should only happen when the borrower fails to appear at the central location.

Conflict of Interest

Development Fund

Clause 32 The Bill designates RBI to create a Micro Finance Development Fund. The fund will be managed by the RBI (under directions of the Central Board of Directors) and can be used to provide loans or grants to MFIs and invest in equity or any other form of capital for MFIs. This allows an RBI-managed Fund to be a shareholder of an MFI or act as a creditor to an MFI. This could create a conflict of interest given the role of RBI as a regulator. The Committee on Banking Sector Reforms (Narasimham Committee II) had observed that it was inconsistent with the principles of effective supervision for the regulator to be the owner of a bank.⁸ Consequently, ownership of the State Bank of India was transferred to the central government with the enactment of the State Bank of India (Amendment) Act, 2007. Given that a precedent has been set to prevent a conflict of interest, it is unclear why an RBI-managed fund is allowed to invest in and lend to MFIs.

Delegation of powers

Clause 42 The central government may, in consultation with RBI, delegate the powers of RBI to NABARD or any other agency. The only exceptions are the powers related to winding up of MFIs and imposition of penalties. As NABARD is also a lender to MFIs, there could be a conflict of interest if it is also given regulatory powers.

Inclusion of Insurance and Pension under Micro Finance

Clause 2 (1) (j) Pensions and insurance services are included under the definition of micro finance services. Typically, MFIs provide these services acting as agents. Currently, the insurance sector is regulated by the Insurance Regulatory and Development Authority while the pension sector is regulated by Pension Fund Regulatory Development Authority. There is no mention of either regulator in the Bill. The 2007 Bill did include insurance and pension services under the definition of micro finance services. However, unlike the current Bill, the 2007 Bill explicitly stated that insurance and pension services would be regulated by the respective regulatory authorities.

Micro Finance Development Councils and Committees

Clauses 3, 8 and 10 The Bill provides for the appropriate government to create the Micro Finance Development Council/Committee at the central, state and district levels to oversee the sector. The national council would promote the industry by advising the central government on policies, establishing a credit information bureau and the working of the grievance redressal mechanism. In addition, the central government is responsible for examining reports about recovery practices from states. The State Councils and District Committees also oversee micro finance activities in the states including methods of recovery and indebtedness. The Bill uses the word “may” and not “shall” for the constitution of these bodies. It is unclear why the establishment of the central and state councils and district committees is not mandatory.

Appendix: Malegam Committee Recommendations

In October 2010, the RBI’s Central Board of Directors set up a Sub-Committee, chaired by Y.H. Malegam, to study the issues and concerns in the micro finance sector. In the terms of reference, the sub-committee was asked to review, examine and make recommendations regarding:

- The definition of microfinance and MFIs
- Prevalent practices with respect to interest rates, lending and recovery practices
- Role of associations and bodies of MFIs could play
- A grievance redressal system

The Table on the next page provides a summary of the key observations and recommendations of the Malegam committee.

Table 2. Key observations and recommendations of the Malegam Committee

Issue	Recommendations
Regulatory scope	Separate category to be created for NBFCs operating in the microfinance sector. NBFC-MFIs can only lend to borrowers with a household income of less than Rs 50,000.
Interest rate	24% cap on individual loans; margin cap of 10% on large MFIs (loan portfolio exceeding Rs 100 crore) and 12% for rest. There should only be 3 components in pricing of the loan: (i) processing fee (not exceeding 1% of the gross loan amount), (ii) interest charge and (iii) insurance premium.
Loans	Maximum loan amount of Rs 25,000. Individual borrowers have to be a member of a JLG; borrower cannot be a member of more than one SHG/JLG. No more than two MFIs should lend to the same borrower.
Prudential norms	All NBFC-MFIs should have a minimum net worth of Rs 15 crore composed of Tier 1 capital. NBFC MFIs should maintain a capital adequacy ratio of 15%. MFIs should maintain an aggregate provision for loan losses (at least 1% of outstanding loan portfolio).
Conduct of MFIs	Responsibility of not using coercive methods of recovery lies with the MFIs. Each MFI should establish a grievance redressal procedure. Regulator should monitor that MFIs have a proper Code of Conduct and system of supervision of field staff. All recoveries should be made at a central place. Regulator should publish a client protection code to be accepted and observed by MFIs.
Credit information bureau	One or more credit information bureaus should be established; all MFIs should join a bureau.

Sources: Malegam Committee; PRS.

Notes

1. This Brief was prepared on the basis of the Micro Finance Institutions (Development and Regulation Bill, 2012 introduced in Lok Sabha on May 22, 2012.
2. N. Srinivasan, "Microfinance India State of the Sector Report 2011", SAGE Publications, 2012.
3. 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, Reserve Bank of India, (Chairman: Shri Y. H. Malegam), January, 2011.
4. Study on Interest Rates and Costs of Microfinance institutions, Small Industries Development Bank of India, January 2011.
5. Statistical Tables Relating to Banks in India 2009-10, Reserve Bank of India, March, 2011.
6. Non Banking Financial Company-Micro Finance Institutions (NBFC-MFIs) – Directions – Modifications, Reserve Bank of India, August 3, 2012.
7. Guidelines on Fair Practices Code for NBFCs, Reserve Bank of India, March 26, 2012.
8. Report on Banking Sector Reforms, Narasimham Committee II, Reserve Bank of India, 1998.

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