

## CHAPTER 4

### Organisational, Legal and Other Issues concerning mFIs

4.1. Beginning with various social and welfare activities, NGOs have, over the years, graduated into mF, mostly as a continuum to their non-financial development activities. Consequently, they face diverse organisational, legal and other constraints which have arisen mainly due to their incorporation as non-profit organisations, voluntary character and the inherent difficulties in mixing developmental and social welfare activities with financial services. The constraints faced by these institutions are discussed in this chapter.

#### 4.2. Organisational Structure of mFIs

4.2.1. The Task Force has examined the organisational structure of various microfinance outfits and observed that while almost all ground level units are generally informal, the intermediate structures are formal registered bodies. The mFIs generally lend through small informal groups like SHGs or Grameen<sup>1</sup>, although assisting individuals is not ruled out. At times they also finance through SHGs' federations. An issue has been raised in certain quarters whether the SHGs' federations could be informal. An informal group remains confined only to 20 persons to retain its legal entity, and is a close-knit association of people with mutual understanding and a sense of solidarity. Such cohesion and understanding may not be available in a broad based structure. Any financial institution or bank dealing with such informal structures or associations of the intermediate type may, therefore, face operational and legal problems. The Task Force therefore feels that while SHGs or other ground level groups could be informal for various practical and operational advantages, any intermediate structure should be a registered body.

4.2.2. As regards regulation of the grassroots level structures, the Task Force has observed that at present SHGs or the groups follow the guidelines as suggested by their respective promoter institutions or NGOs. By and large, such an arrangement is working satisfactorily and the guidelines followed by the groups have come to be regarded as bye-laws. The Task Force does not feel it necessary to suggest any instructions for the SHGs in this regard. As for SHGs' federations, they need to be formed as registered bodies and the regulations as suggested in chapter 3 for such institutions will be applicable to them if they take up financial intermediation.

#### 4.3. Incorporation and Registration of mFIs as Companies

4.3.1. Under existing provisions, an NBFC seems to be the only organisational structure that an mFI, especially those which operate at levels above the cut-off level, can take. The Task Force has observed that some mFIs have already registered themselves as not-for-profit companies under Sec.25 of the Companies Act, 1956. As these are registered under the Companies Act, the Task Force understands that these are like NBFCs and all attendant regulations of the RBI as are applicable to NBFCs will be applicable to such Sec.25 companies also.

4.3.2. In addition to above, certain mFIs are also registered as for-profit companies under the Companies Act, 1956. Although they are carrying out microfinance activities, they are yet to be registered by the RBI as an NBFC. As per latest instructions of RBI, no NBFC with minimum net owned funds (NOF) of less than Rs.25 lakh is eligible to accept public deposits. Such companies

have to stop acceptance of deposits forthwith. Earlier, in January 1997, the RBI had asked all NBFCs to compulsorily register with RBI by 08 July 1997. Such NBFCs were allowed to carry on their business unless registration was denied to them. Further, these NBFCs are now required to file returns to the RBI in prescribed formats on quarterly basis indicating their reserve position and maintenance of liquid assets irrespective of whether NBFCs hold public deposits or not. The NBFCs undertaking microfinance activities also have to comply with a large number of statutory requirements to carry on their business as NBFCs. These compliances embrace, besides equity, a lot of other areas of regulation involving liquid assets, rating requirements and prudential norms. Recently, for the new NBFCs, the RBI has enhanced the NOF requirement to Rs. 2 crore.

4.3.3. The Task Force has observed that the mF-NBFCs, even though deal exclusively with the poor, are subjected to the same regulations as are applicable to other NBFCs. However, due to their special focus, it is inclined to believe that there is a need for a separate dispensation for the existing NBFC-mFIs as also the prospective mFIs who would be interested in registering themselves as NBFCs. The Task Force notices that at present financial companies are categorised into 9 different types of NBFCs. While most of them are regulated by the RBI, there are certain types of companies regulated by other institutions as well, e.g., by the National Housing Bank (NHB). This categorisation of the NBFCs has arisen mainly because of their special functions, e.g., housing finance, leasing, hire finance etc. Further, it may be observed that the equity requirement, registration etc. are not the same for these different types of NBFCs. For example, "Mutual Benefit NBFCs", commonly known as "NIDHI" companies are notified by GOI under Sec.620 A of the Companies Act. The NIDHI companies have a lower net owned fund (NOF) requirement which has been raised recently from Rs.10 lakh to Rs. 25 lakh. The Task Force is of the opinion that in view of the crucial importance of mF sector *per se*, voluntary orientation of such companies and focus on poor, there is an imperative need for a special dispensation for NBFCs which take up microfinance separately or in tandem with other financial and non-financial development activities. Exclusive dealings with the poor and registration under Sec.25 of the Companies Act would then be the prime consideration for the special categorisation of these companies. Such companies may be treated and recognised as "mF companies". Such companies may also have to be given special consideration in the matter of net owned funds and other regulations. As the mF-NBFCs would be focusing on the poor and the NOF for mutual benefit companies has been kept at Rs.25 lakh, the Task Force considers that the NOF for the mF companies may also be prescribed at Rs. 25 lakh. Since these companies will be of a new type, there may be a need for notification by GOI for their establishment and special status as proposed.

4.3.4. The Task Force understands that GOI has granted registration under Sec. 12 A of the Income Tax Act, 1961 to a certain microfinance company (NBFC) registered under Sec. 25 of the Companies Act, treating it virtually at par with NGOs. While such registration under the IT Act *ibid* will have the effect of exemption from payment of income tax for such a company, such a dispensation for all similar companies will go a long way in professionalising the mF sector for the benefit of the poor.

#### **4.4. Registration of mFIs**

4.4.1. In the recent past, there has been a marked increase in the number of mFIs. In several states, NGOs are coming forward to take up microfinance as one of their core activities. Simultaneously, it has also come to the knowledge of the Task Force that in many states prospective NGO-mFIs are having difficulty in getting their organisations registered with predominant focus on microfinance. The major objection of the registering authorities could be

extensive financial transactions that these agencies are likely to undertake which bears an element of "profit making" due to the interest charged on mF loans. The Task Force feels that it may be logical to treat microfinance as a service for relief to the poor and incidental to the main charitable objects of the proposed societies. Accordingly, it recommends that new and prospective societies with microfinance as one of the major activities may be registered as non-profit organisations under the relevant Acts.

#### **4.5. Acceptance of Deposits**

4.5.1. The Task Force is of the opinion that Section 45 S of the RBI Act is not restrictive so far as mobilisation of regular thrift by SHGs is concerned. The reason is that SHGs being groups of persons up to 20 members are not having separate legal entity /status independent of the members who form it and the thrift mobilised is only from its "members". The thrift mobilised by the SHGs is also in the nature of quasi-equity and does not have the presence of two parties, one as giver and the other as receiver, as in the case of usual bank deposits. Thus, mobilisation of thrift by SHGs is basically for creating own capital to leverage (bank) loans besides inculcating the habit of self-help. RBI instructions on SHG-bank linkage programme therefore recognises acceptance of savings by the SHGs from its own members at periodic intervals as an essential component of mF banking.

4.5.2. As regards mobilisation of savings by the NGOs and SHGs' federations, the Task Force observes that the intention of these agencies is not to utilise the mobilised savings for financing activities of the poor outside the purview of their developmental schemes. It is therefore inclined to believe that there is no deliberate violation of Sec. 45 S of the RBI Act on the part of such NGOs and SHGs' federations and therefore, the same may be treated, at best, as a technical violation. Accordingly, as indicated in para 3.11.6 of chapter 3, the Task Force reiterates its opinion that RBI may treat them as incorporated bodies for the limited purpose of the Section 45 S of the Act *ibid*. RBI may therefore issue necessary clarificatory instructions for the purpose.

#### **4.6. Borrowings**

4.6.1. The Task Force observes that most of the NGO-mFIs had started their credit operations from grants received from national / international donors. However, any large scale expansion of mF programmes by such agencies may have to depend on borrowings (from the formal banking sector) at least for meeting the loanable funds requirements. However, unless the bye-laws of these agencies include a borrowing clause, they may not be able to borrow, least of all for the purpose of on-lending. Practical experience of many such NGO-mFIs indicates that these agencies face difficulty in amending their bye-laws as the respective Registrars generally do not allow such amendments despite positive intervention on the part of the GOI as indicated in para 3.3.1. of chapter 3. The Task Force reiterates that wherever the NGOs undertake mF activities, even limited to provision of micro loans, they may be allowed to secure the necessary enabling amendment to their bye-laws so as to be able to borrow for on-lending. Suitable instructions from the Ministry of Finance, GOI, would go a long way in this regard.

4.6.2. The Task Force has observed that the savings accretion in the microfinance sector, even though characterised by a steady growth, is not sizeable enough to meet the entire credit requirements of the mF sector on a sustainable basis. All the constituents of the mF sector will therefore have to borrow from the formal banking sector (including specialised development

banks) sooner or later for sustaining and expanding their programmes. Even the specialised mF companies will have to resort to borrowings from the banking sector as also from other term lending institutions, as they would not be able to mobilise much deposits due to their typical clientele base. The Task Force is inclined to recommend a favourable approach towards provision of credit to the mFIs by the banking sector. The modalities of such funding have been discussed in detail in chapter 6. It is felt that these agencies would require a different dispensation in the matter of collaterals and other lending norms. On their part, NABARD, SIDBI, HUDCO and other term lending institutions may also consider providing credit support to mFIs for their lending in rural, semi-urban and urban areas.

## **4.7. Equity**

4.7.1. The Task Force has observed that, as of now, most of the mFIs, being NGOs, do not have the concept of equity. True to their origin and initial mode of operation, the NGOs have depended for their operations almost exclusively on external funds, received mostly in the form of grants. Of late, with the opening up of the funding channel in the form of revolving fund assistance (RFA) or loans convertible to grants from NABARD, RMK and SIDBI, additional sources of funds have opened up before them. At the moment, these agencies do not prescribe any debt-equity consideration for their assistance to the NGO-mFIs due to the typical structure of NGO-mFIs. The concept or idea of holding equity has, therefore, not developed among the NGO-mFIs. The lack of equity orientation also disarms the NGOs from leveraging debt in a large way.

4.7.2. As mentioned above, many NGO-mFIs have been able to procure grants, particularly from international donor agencies, for their mF activities. The existing rules require the interest income on the funds received from the donor agencies also to be treated as part of the foreign contribution and reported as such in the statements furnished to the GOI. It is understood that if such funds are to be used for providing seed capital to the SHGs, no prior permission is required when the funds are received by an agency registered with the FCRA. The NGOs, however, find it difficult to set up mF-NBFCs as the Societies registration Act prohibits transfer of assets and resources of a society from being passed on to another agency even as equity. As per existing rules, the assets or resources could be passed on only to another society. Thus, even if an NGO has some resources, it is not in a position to use them as share holding in an NBFC promoted by itself. The Task Force recommends that necessary amendments be made in the Societies Registration Act (and other similar Acts) to allow NGOs to float specialised mF companies and hold equity in them from out of resources of the NGOs.

4.7.3. At present, start-up capital is by and large, received by the mFIs from the international agencies either by way of grant assistance or soft loans. With the development of mF sector, a number of mFIs may be requiring such assistance during their initial period of growth. Also, some of them may be setting up NBFCs under the Companies Act for which they will be requiring equity support. The Task Force examined the issue in the context of the present arrangements for mFIs receiving equity and start-up capital from national and international organisations. In order to make these mFIs grow, the Task Force strongly considers the need for meeting such requirements of the mFIs within the country and in a flexible manner. Already, NABARD and SIDBI are engaged in supporting at the national level the development of mFIs. However, these institutions are not able to provide such assistance from out of their own resources due to two reasons, viz. lack of adequate funds for provision of start-up capital vis-a-vis the demand for such funds for the mFIs and cumbersome provisions in the NABARD Act for providing equity support. As far as funds requirements are concerned, GOI may have to provide budgetary support to NABARD and SIDBI for the purpose. On their part, these institutions will bring flexibility in

extending equity and start-up capital to the mFIs, if necessary, by amending the present provisions for the same. The matter is further discussed in para 6.6 of chapter-6.

4.7.4. The Task Force has examined the issues relating to raising of equity for microfinance NBFCs and observes that unless a favourable policy atmosphere is created for this vital aspect of their functioning, their growth would be stunted and they may not be in a position to play their role in banking with the poor effectively. The Task Force also suggests that on the lines of the infrastructure companies, a new Section 10(23-H) may be introduced in the IT Act to exempt any income from dividends or capital gains from investments in the equity shares of microfinance companies. This may enthruse prospective investors to put in funds in microfinance NBFCs.

4.7.5. The Task Force deliberated the issue of investments by foreign agencies in the microfinance sector in the context of liberalisation of the financial sector, more particularly relaxation relating to foreign investment in various sectors. It understands that a number of mFIs are negotiating with foreign (donor) agencies for equity capital for expanding their mF activities. It is reported that even though many of these foreign agencies are willing to invest in microfinance companies, there are certain restrictions of minimum size of investments as well as the purposes for which foreign investment is allowed. With a view to attracting foreign investment in the mFIs, the FIPB guidelines will have to include investment in the microfinance sector by foreign agencies as an eligible channel of sourcing funds for microfinance companies. The requirement of funds in each case is however expected to be much less than the minimum investment of US \$500,000, stipulated at present under FIPB guidelines. Incidentally, it may be observed that Grameen Trust, Bangladesh supports Grameen replication initiatives undertaken by mFIs with funds of the order of US\$ 50,000. Keeping the above in view, the Task Force is of the opinion that the minimum amount of foreign equity for mF may be prescribed at US \$ 100,000. Further, with a view to expediting the process of channelisation of foreign investment for the mF sector, it recommends that all such investments for mFI sector may be directly cleared by the RBI without reference to the FIPB. As RBI is expected to oversee the functioning of the mF sector as a whole, the Task Force also recommends that the RBI may be vested with such powers as required for providing clearance/approval for proposals relating to all foreign investments in the mF sector.

## **4.8. Taxation**

4.8.1. The SHG concept is based on the principle of mutual help and cooperation. Thus, the borrowers' group in the form of SHGs' federations also work on the principle of mutuality. The Task Force has observed that in a comparable situation, Sec.10(23D) of the IT Act exempts the income of registered mutual funds from income tax. Similarly, Sec.10(23F) exempts the income by way of dividends or long term capital gains of a venture capital fund or a company. In view of these exemptions, it may be reasonable to seek a similar status for federations (howsoever registered) of borrowers or borrowers' groups (SHGs' federations), since these also constitute a form of mutual fund and being an emerging and nascent line of activities has all the basic elements of a new venture to qualify for concessions as are applicable to venture funds.

4.8.2. At present, certain types of financial corporations like the ones engaged in long term finance for housing, industrial or agricultural development or development of infrastructure facility, are allowed tax exemption to the extent of 40% of their total income if the same is placed in a special reserve. The Task Force observes that microfinance is equally crucial for the development of the rural economy and any support should be viewed as an incentive for its

growth. Accordingly, the Task Force recommends that the Section 36(1)(viii) of IT Act, 1961 may be suitably amended to include microfinance to the list of approved purposes.

4.8.3. Microfinance, at the present stage of its development, is characterised by excellent repayment performance in the case of SHG linkage and other credit delivery models. However, with the gradual increase of the scale of operations and extent of lending by various agencies, there may be a slowdown in the repayment performance of the mFIs. Prudent banking practice calls for provisioning for bad and doubtful debts. Under Sec.36(1)(vii-a) of the IT Act, the benefit of tax deduction in regard to provisioning for bad and doubtful debts is available to the banks but not to the NBFCs. The Task Force recommends that the above Section may be duly amended to include mF-NBFCs. This will encourage the NBFCs to make proper provisioning.

#### **4.9. Local Area Banks**

4.9.1. The Task Force has observed that after the announcement of the Hon'ble Union Finance Minister and issuance of instructions by the RBI on local area banks (LABs) in August 1996, some NGOs and mFIs have shown interest in channelising their financial activities through such banks. Such initiatives by mFIs to set up LABs with focus on microfinance may be encouraged. Given the high cost structure of the existing commercial bank branches, the possibility of some of them floating LABs by restructuring their rural branches to take up mF may also be explored and encouraged.

#### **4.10. Highlights of the Chapter**

1. *"mF companies" [NBFC-mFIs] proposed*

*with lower NOF of Rs. 25 lakh modified regulations eligibility for registration under Section 12 A of IT Act.*

1. *NGOs and SHGs' federations to be kept outside the purview of Sec.45 S of the RBI Act and necessary clarificatory instructions to be issued by RBI.*
2. *Registration of NGOs with mF as one of their major objectives to be allowed*
3. *Amendment to bye-laws to be allowed enabling the NGO-mFIs to borrow*
4. *Amendments to Societies Registration Act to allow NGOs to float specialised mF companies and hold equity from out of NGO resources.*

5. *Meeting the requirements of start-up capital, equity of the mFIs by national institutions suggested*

- *budgetary support from GOI to NABARD and SIDBI for the purpose;*
- *amendment to present provisions by these institutions, whenever necessary.*

1. *Relaxation of FIPB guidelines to allow entry of foreign capital for mF*
  - *minimum amount of investment at US \$100,000; and*
  - *RBI to be vested with powers for issuing clearance*

1. *Insertion of a new Section 10 (23-H) in the IT Act to exempt income from dividends or capital gains from investments in the equity shares of mF companies proposed*

2. *Amendments to Sections 10 (23-D), 10 (23-F), 36(1)(vii-a) and 36(1) (viii) of the IT Act proposed to provide exemptions /concessions to mFIs on the lines of venture capital/mutual funds/ banks*
3. *LABs with focus on mF to be encouraged. Commercial banks to be allowed to promote LABs to restructure their rural branches .*

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<sup>1</sup> Groups of five promoted by Bangladesh Grameen Bank.