CHAPTER 3

Regulation and Supervision of mFIs

3.1. Present Arrangements

3.1.1. Regulation and supervision of the formal banking institutions is well organised under various Acts, viz. B R Act, RRBs Act, Cooperative Societies Acts, and RBI Act. While RBI supervises commercial and urban cooperative banks and NBFCs, NABARD has been authorised to supervise RRBs and cooperative banks on behalf of RBI. Regulation is, however, almost entirely attended to by the RBI. As regards mFIs, none except those registered as NBFCs and cooperatives are presently treated as part of the financial sector. As most of them are registered as societies or trusts, the question of their supervision and regulation from the financial angle had not arisen. Except submission of annual accounts and a report on their operations to the authorities under the Acts of their registration, these agencies are not under any statutory compulsion to comply with specified norms or instructions in respect of their mF activities encompassing mobilisation of savings and granting of loans.

3.2. Incorporation and Registration of the mFIs

3.2.1. The Task Force observes that a large number of mFIs in our country are presently registered to function as non-profit organisations. As discussed in para. 2.3, chapter 2, there are three forms of registration available in India for incorporating a non-profit organisation :

1. Societies under the Societies Registration Act, 1860 or analogous State Acts
2. Public Trusts registered under the Indian Trust Act, 1882
3. Non-profit companies registered under Section 25 of the Companies Act, 1956

3.2.2. It is observed in this regard, that a few states have enacted their own Societies Registration Act, e.g., The Karnataka Societies' Registration Act, 1960, The Bihar Societies Registration Rules 1965 and the Tamilnadu Societies Registration Act, 1975. In certain states like Maharashtra and Gujarat, there is a Public Trusts Act. Under the above Act, it is obligatory for the institutions that are of the nature of Public Trusts to get themselves registered. Further, in the state of Maharashtra, if a non-profit body is registered as a society, then it is obligatory to register the same under the Public Trusts Act also. Such dual registration under the Societies Act and the Public Trusts Act is generally required in places where the State Public Trusts Act is in vogue.

3.2.3. The Task Force has noted that the Societies Registration Act was basically enacted to formalise voluntary associations of like-minded people for promotion of literature, science, fine arts or for the diffusion of useful knowledge, political education or for charitable purposes. With the passage of time, the field of social and developmental interventions has widened, and a large number of such institutions with a wide range of objectives directed towards social and economic upliftment of the people in the lower strata of the community have started functioning. Some of these organisations, as part of their overall objectives, have started providing certain types of financial services in a limited way. Many of these organisations have been registered long back and do not even have any mention of provision of savings and credit services in their objectives clause. Reservations have been expressed at times in certain quarters whether the agencies registered under these Acts can undertake mobilisation of savings and credit disbursement as lawful activities, although such activities are targeted to the classes of people whom they are expected to serve. On the one hand, the agencies are apprehensive of the legality of their

financial intermediation activities, while on the other a question remains about regulation and supervision of such financial activities.

3.3. Recognition of NGOs' Role as mFIs

3.3.1. The Task Force observes that in the past few years, there has not only been a general acceptance of the work of such agencies (NGOs) as microfinance institutions for delivery of financial services to the poor, particularly women, but also many of such initiatives have been publicly lauded and other NGOs encouraged to take up similar mF activities. In the recent past, agencies have been registered in many states with specific provision to undertake such financial activities. The GOI have set up the Rashtriya Mahila Kosh (RMK) as a society registered under the Societies Registration Act, 1860 under its Department of Women and Child Development, to promote, among other things, microfinance through NGOs and Women Development Corporations of the states. Certain departments of the GOI and state governments are using NGOs as channels for delivery of financial services in tandem with various development programmes. During the deliberations at the Microcredit Summit in Washington in February 1997, Shri S S Boparai, the then Secretary to the GOI, Ministry of Industries, Department of Small Scale Industries, not only placed NGOs' initiatives in providing microfinance to the poor on record, but went ahead to assure the World Forum of the Government of India's full commitment and all possible assistance, both financial and non-financial, to NGOs in this regard. The Ministry of Human Resources Development, GOI, has also accepted the role of NGOs in providing microfinance and has written to the state governments to assist NGOs in the amendment of their bye-laws to facilitate borrowings for further onlending (Annexure- VI).

3.3.2. Under the SHG-bank linkage programme also, lending to NGOs for further on-lending to SHGs has been recognised as a legitimate financial intermediation activity of the NGOs. More recently, while communicating total deregulation of the rates of interest on loans by banks to microcredit organisations, as part of the monetary policy announcements by the Governor, RBI for 1999-2000, RBI has clearly recognised the financial intermediatory role of the NGOs , among other agencies (Annexure-VII).

3.3.3. It is, therefore, felt that through various actions of the GOI and RBI, there are sufficient indications of the acceptance and recognition of the role of NGOs and other voluntary agencies as mFIs. The Task Force, however, appreciates the need for proper regulation and supervision of their microfinance activities for filling up the vacuum in the relevant Acts meant for incorporation of these agencies.

3.4. Need for Regulation and Supervision

3.4.1. The need for regulation and supervision of mFIs arises from several considerations. While all types of financial institutions irrespective of their origin and mode of registration and incorporation have to report statutorily to RBI, NABARD or to some specified agency like SEBI or National Housing Bank, the NGOs engaged in providing microfinance services do not have to comply with any statutory requirement in this regard. These agencies mainly purvey small sized credit to their clients besides, in some cases, mobilising small savings from them.

3.4.2. Although most of these agencies accept periodic savings only from their target clientele to whom they have sanctioned loans, there may be cases, at least at certain points or phases of operations, when the accumulated savings of all or certain members are higher than the aggregate loans availed by them. In the wake of the successive announcements on microfinance by the Hon'ble Finance Minister while presenting the Union Budget and the encouragement given by RBI for providing bank credit to microcredit organisations, it is likely that more institutions would take up mF services in a large way. As experienced so far in the mF sector activities, savings would be an important component of the financial services provided by them. Therefore, there is an imperative requirement for protecting the interests of all the small savers who, quite often, may not even have any worthwhile document to show as proof of their meagre savings. Being part of the financial sector, the need for regulation of NGO-mFIs to protect the poor from some institutions of doubtful credibility, as also poor fund management capabilities can hardly be questioned.

3.4.3. The composition of the savers under the fold of the mFIs needs a close look. A question is also raised as to what would be the status of the savers with the mFIs who are not loanees or were not loanees earlier also. It is observed that the savers under the fold of mFIs are generally poor and members of one or the other of their development interventions awaiting coverage under their credit schemes. **It is also understood that unlike in the case of primary cooperatives, there is no concept of "membership" of the NGOs for the savers and loanees, as the membership *per se* for the societies registered under the Societies Registration Act, 1860 or the Indian Trust Act, 1882 comprises the promoters of the societies who themselves cannot avail of any benefit from the societies. Consequently, the "members" of the development programmes of such societies can be classified at best as "clients" or "beneficiaries" of the various interventions of the societies. Hence, savings mobilised by the NGOs are virtually collected from the members of the public. This reinforces the need for regulation of the mFIs further.**

3.4.4. Credit, even though accompanied with other social development functions, is a commercial activity. Whether it is accompanied with savings mobilisation or not, there is need for regulation from the point of interest rates, terms of credit, etc. Further, under the Usurious Loans Act, 1918, even the persons carrying on business of money-lending have to obtain licence from the appropriate authority. It is quite logical that NGO-mFIs also are brought under some regulation.

3.4.5. The mFIs also need to observe financial discipline, whether self-imposed or dictated by the state, for sustainability of their microfinance operations. The Task Force is of the opinion that rules governing the functions of NGO-mFIs have to be clearly spelt out if this sector has to witness orderly development and sustained growth.

3.4.6. Significantly, a large number of donor agencies have shown interest in supporting mF activities through SHGs or other types of delivery mechanisms. Further, different government departments are also providing funds for microfinance activities with varying terms of service, interest rates, etc. In the entire financial sector, mFIs comprising institutions of the NGO family are the only ones, which are outside the purview of any institutionalised system of reporting. It is, therefore, also necessary to have a reporting system that enables the RBI and the GOI to have a complete picture of the microfinance scenario in the country including, *inter alia*, the agencies involved, the direction, volume, and sources of the flow of funds through these agencies, and terms of financial transactions including interest rates, loan periods, etc.

3.4.7. The Task Force is of the view that the regulation of the mFIs would be *sine qua non* for development of this sector. It also took into account the view that regulation could stifle the growth of mF sector and rob it of its flexibility and informality in operations. But, having regard to

the interests of the small savers, the need for proper credit discipline for the growth of this sector, such regulation of mFIs is considered essential. The Task Force, therefore, wants to emphasise that the spirit of the regulation would have to be pro-active and development-oriented for the growth of mF sector.

3.4.8. **The Task Force has examined at length the scope of regulation and supervision and is of the view that the regulation of the mFIs may cover registration, reserve requirements, compliance with prudential norms, directions in respect of microfinance operations, and reporting system to the competent controlling authority. Supervision of the mFIs may comprise on-site inspection and off-site supervision to ensure that the functioning of the mFIs is not detrimental to the interests of the people.**

3.4.9. While examining the above components of regulation of mF sector, the Task Force considered the possibility of two modes of effecting the regulations, viz. an external regulation mechanism predominantly operated by non-mFIs, indirectly associated with the sector and a mechanism of self-regulation by the mFIs themselves. The Task Force considered both the mechanisms, and in view of the changing environment in the financial sector of the country towards decentralisation and privatisation, it strongly feels that self-regulation would be a more appropriate mode for the mF sector.

3.5. Self-Regulation

3.5.1. Rationale for Self -Regulation

3.5.1.1. Self-regulation can play an important part in the regulation of microfinance institutions, most of which have their roots in voluntary service. In many countries of the world, self-regulation has taken the role of part governance of institutions in the financial sector. There are several distinct advantages of self-regulation :

1. self-regulation brings standard and acceptable level of performance, service and code of ethics for the members;
2. self-regulation ensures spontaneity and involvement of the institutions in compliance of various statutory provisions;
3. self-regulation minimises the cost of overseeing the operations by the statutory authority; and
4. there can be a division in the area and powers of regulation whereby statutory authorities may concentrate on the broader aspects of regulation leaving the rest for the self-regulating authorities.

3.5.2. Evolution of Self Regulatory Organisations (SROs)

3.5.2.1. The Task Force has looked into the evolution and growth of SROs in different sectors of the economy in India and abroad. It has been observed that the Indian Banks' Association (IBA) frames guidelines for many areas of functioning for the member banks like preparing ground rules for deposit mobilisation, service charges, simplification of application formats for disbursement of small loans, etc. The various Chambers of Commerce are found to ensure

adherence or compliance of certain statutory regulations. Likewise, associations of professionals like those of chartered accountants, architects and doctors have been found to set professional standards for the practitioners in the respective fields.

3.5.2.2. The Task Force also observes that the entire cooperative sector [including credit cooperatives] in Germany is self-regulated to a great extent. The auditing federations of the cooperatives in Germany are responsible for organising and maintaining the auditing structures and carrying out audits of all cooperative banks and structures in the country within the context of the three relevant laws, viz. the Cooperative Societies Act (CSA), the German Banking Act (BA), and the German Commercial Code (CC). The organisation of the Cooperative Auditing Federations (also called auditing associations) gradually developed over time from the cooperatives themselves. The rural and urban cooperative banks constituted, at the end of the nineteenth century, their own federations with particular emphasis on auditing. At present, the German Cooperative and Raiffeisen Confederation with 11 regional (sub)-federations and 6 specialised auditing federations undertake the audit of the entire cooperative sector in the country. A striking feature of this audit is that it is a statutory and compulsory requirement for all cooperatives and is done on annual basis covering both financial and managerial areas. No regular inspection is understandably carried out by the Central Bank or Federal Banking Supervisory Office (FBSO) of Germany. Based on the audit reports, the FBSO can take necessary action or conduct on-the-spot inspection, if necessary.

3.5.2.3. The Task Force understands that already there are efforts among some NGO-mFIs to form associations. This is a very welcome development and deserves to be encouraged. Such associations, if developed on sound lines, can specify and oversee, among other things, the adherence to performance standards for their members. They can also provide capacity building support to the member mFIs and help in attaining the required standards. They can also compile data on operations of such mFIs for use by central banking authority to facilitate periodic review of policies in regard to mFIs. The Task Force observes with interest that the RBI has been taking the help of the IBA in various operational matters concerning the banks in general. For example, pursuant to the recommendations of the High Level Committee on flow of Credit to Agriculture, the IBA was requested by the RBI to work out simplified application forms, documents etc., for agricultural loans and to undertake rationalisation of internal returns of banks.

3.5.2.4. In the light of the above experiences and the need for regulating the mFIs in an environment-friendly manner, the Task Force recognises the mechanism of self-regulation and the need for encouraging promotion of Self-Regulatory Organisations (SROs).

3.5.3. Functions of SROs

3.5.3.1. The Task Force observes that the SROs will have a prominent role in the growth of the mF sector in the country by undertaking proactive regulation and supervision of the mFIs as also providing training, guidance and taking up the causes of microfinance in general. The major functions of the SROs could be :

1. overseeing the functioning of the mFIs as their base level regulator and ensuring proper functioning;
2. registration of new mFIs and issue of permission for conduct of mF activities;
3. evolving proper systems for maintenance of accounts and other records for the mFIs and groups promoted and served by them;
4. setting standards for the member mFIs in the major areas of their functioning. Such standards could be of the nature of ground rules for provision of financial services to the

best interest of the people as also avoiding unethical competition among various agencies functioning in particular area;

5. conducting audit and inspection of the mFIs and the groups served by them;
6. devising proper system of reporting for the mFIs, collecting periodic information, their compilation and onward transmission to RBI;
7. undertaking training of the functionaries of the mFIs in all aspects of microfinance activities including promotion of ground level microcredit structures and their nurturing and capacity building of these institutions in various ways; and
8. representing mFIs in various state and district level fora like State Level Bankers Committee[SLBC], District Consultative Committee[DCC], etc. and liaising with the government and banks.

3.5.4. Structure of the SROs

3.5.4.1. As has been the experience from the comparable existing institutions, the Task Force observes that the SROs will have to evolve from the mF sector itself. With a view to encouraging the growth of sustainable organisations on sound lines, it is desirable to stipulate SROs with a membership of a minimum of 50 mFIs. However, during the initial stages of their development, the SROs may not be able to muster the required membership. Therefore, relaxations in regard to such conditions of minimum membership of 50 may be given in respect of the SROs set up for the first three years of their working.

3.5.4.2. Further, in some of the states, the growth of mFI sector is still evolving while in other states, especially in the southern states and Orissa, a large number of NGO-mFIs are already functioning. The SROs may, therefore, be either region-specific or state-specific depending upon the growth of the mF sector in the region.

3.5.4.3. Having considered the examples of comparable institutions in various sectors, the Task Force considers that an SRO will have to be duly registered as a non-profit organisation as a society or a trust or a company under Section 25 of the Companies Act, 1956. With a view to ensuring that the SROs function on democratic lines, the Task Force feels that the SROs should have a duly elected governing body and that the governing body shall ordinarily not remain in office continuously for more than 3 years.

3.5.5. Recognition of the SROs

3.5.5.1. The prime condition for the SROs to play their assigned role will be their own recognition by a competent authority. The Task Force has examined the statutes recognising self-regulating bodies in other countries and has observed that under the Financial Services Act, 1986 of U.K., a "self regulating organisation" means a body (whether a body corporate or an unincorporated association) which regulates the carrying on of investment business of any kind by enforcing rules which are binding on persons carrying on business of that kind either because they are members of that body or because they are otherwise subject to its control. Further, an SRO has to apply to the State for declaring it to be a recognised self-regulating organisation for the purpose of the Act. In Germany, in accordance with Section 54 of CSA, each cooperative bank must belong to a federation of its choice which is officially entitled to conduct audit. A cooperative bank can withdraw its membership from one federation but it has to compulsorily seek membership of another federation.

3.5.5.2. As mentioned earlier, the associations of mFIs can play a responsible role in the grooming of an SRO. The Task Force feels that various apex level institutions like NABARD, SIDBI and RMK, which have experience in dealing with the sector, may contribute substantially

towards the development of the SROs. The banks which will have substantial business with the mFIs may also lend a supporting hand in the grooming of the SROs. The Task Force, therefore, recommends that all these institutions may support the cause of the SROs. Further, NABARD, SIDBI, RMK and leading commercial banks may work out, in consultation with prominent mFIs and their associations, norms for recognition of such SROs as well as performance standards of the members. It also suggests that the RBI may take a cue from the British and German models and take necessary steps for developing a mechanism for the recognition of the SROs based on such norms. To facilitate the process, the RBI may constitute a working group of the institutions associated with mF. **The Task Force also observes that in order to recognise the SROs and their regulatory functions, it would be necessary to suitably amend the RBI Act, 1934. This matter is further discussed in chapter 5.**

3.6. Regulation

3.6.1. As indicated above, self-regulation could perhaps be the best mode, but it may take some time for such a mechanism to evolve. The Task Force has deliberated in detail the present status of the sector, the need for innovations, entry of enterprising agencies, business prospects in the sector and necessary legal provisions. It observed that at the present stage of the evolution of the sector there are certain limitations in straightway involving SROs due to the presence of very few associations of mFIs, not all mFIs being members of such associations, technical competence of all such associations not being of required level, quality of information with most mFIs requiring improvement and above all minimum performance standards not being developed for the mFIs. The Task Force is of the opinion that in the best interest of the sector, the process of regulation and supervision of the mFIs may be started immediately by the RBI and the GOI, without waiting for the establishment of the SROs. Under both the dispensations, the essential components of regulation and supervision will remain the same. These are discussed further in the following paragraphs.

3.7. Registration

3.7.1. The first step for regulation is registration with a competent authority. At present, all agencies in the financial sector are registered or given a licence by a designated authority before such agencies commence their operations. But the NGOs engaged in microfinance activities as part of their social agenda are operating independent of the knowledge or licence of any financial authority. While registration under Societies Registration Act, Indian Trust Act or any other Act gives the NGO-mFIs existence as a legal entity, such registration does not vest these agencies, *ipso facto*, with necessary permission to undertake financial intermediation services.

3.7.2. Recognising the need for maximum possible decentralisation, the Task Force observes that a two-tier registration mechanism would be more appropriate for the mFIs. As a first step, all existing NGO-mFIs may be asked to compulsorily register themselves with a designated regional authority. As and when a new agency wishes to take up mF, it would be required to formally apply for registration with this authority. Depending upon the number of agencies, such base-level registration authority may be set up either at the state or regional level. If the operations of an mFI as regards savings mobilisation are of a high order and exceed a pre-determined cut-off limit, the mFI may have to register itself with a central authority at the national level.

3.7.3. In suggesting a cut-off limit for duality in registration, the Task Force was guided by several considerations. The area of operation and activities of a large number of mFIs are small and localised in nature. The mFIs with limited staff and management capability may, therefore, like to restrict their activities to a fairly low level, and the need for regulation will be minimum for them. Such institutions will be quite comfortable in dealing with a regional or local body rather than a national level authority. This will also obviate the need for large scale operations of the national level authority. However, agencies which expand their activities may have to accept all necessary regulations. Such cut-off limit may also provide a reasonable benchmark for application of various prudential norms. The dual nature of registration may facilitate the emergence of regional SROs for acting as the regional registration and monitoring authorities. Eventually, it may even lead to the replacement of the national level authority by a national level SRO.

3.7.4. The relevance and need for registration of the mFIs with the appropriate authority would vary depending upon their size and nature of operations. For small mFIs below the cut-off level of business, registration is mainly for the purpose of reporting the growth of their transactions, and their integration with formal credit system. As regards bigger mFIs with levels of business above the cut-off level, the registration at the national level with the central authority will ensure compliance with regulatory norms commensurate with their activities and level of business.

3.7.5. In future, any NGO considering taking up mF activities will be required to register itself with the regional registration authorities before commencing such activities. However, existing mFIs may need some time to decide their future operations and exercise their option. The Task Force considers that a reasonable period of, say, one year, may be allowed for such NGO-mFIs to get themselves registered with the appropriate authority.

3.7.6. The Task Force observes that there may be some NGOs already engaged in or considering to take up provision of financial services to the non-poor also. The RBI may have to take a separate view in respect of registration and other regulations of such institutions if these institutions do not restrict themselves to dealing only with the poor.

3.7.7. As an important process of registration, the concerned registration authority will have to issue registration number to the NGO-mFIs to enable them to undertake mF activities. The Task Force observes that the authority may consider, inter alia, the track record of the NGO, nature of social services undertaken, nature of mF business proposed to be carried out, period of service in the area, its general reputation and acceptability, financial and manpower resources, etc., while dealing with requests for registration.

3.7.8. The Task Force has examined the need for involvement of mFI associations with the registration procedure and feels that before applying for registration, an mFI would be required to take membership of any one association of mFIs. The recommendation of the association regarding the activities of the mFI will be a crucial factor for the grant of registration number to the applicant mFI. This will also ultimately lead to the development of SROs. Further, the experience of the mFI in the initial years in mobilisation of savings and thrift and disbursement of

credit and its track record will be the major considerations in the issue of registration certificate by the competent authority. The Task Force recognises that there are several associations of mFIs already in existence and hence membership of such associations may not be altogether a new proposition for them. It therefore, feels that the mFIs may take membership of any association of their choice.

3.7.9. The Task Force also avers that in future, financial institutions, banks and all donor agencies, both national and international, will ensure that the mFIs concerned approaching them for any financial assistance are registered with the appropriate authority.

3.8. Classification of mFIs for the Purpose of Regulation

3.8.1. Based on the type of financial services extended and the cut-off level of business, the mFIs may be divided into the following classes for the purpose of regulation :

1. mFIs purveying credit only;
2. mFIs purveying credit and mobilising savings from the clients/loanees (below cut-off limit);
3. mFIs purveying credit and mobilising savings from the clients/loanees (above cut-off limit); and
4. mFIs purveying credit and mobilising savings from the clients/loanees and general public.

3.8.2. The classification as suggested above may be the basis for regulation irrespective of the type of other financial services (like insurance, housing finance) and non-financial services provided by the mFIs alongwith the financial services. The Task Force recommends different sets of regulations for the different classes of mFIs.

3.9. Cut-off Level of Business

3.9.1. The Task Force has observed with interest that the levels of business and activities of the NGO-mFIs are not alike. While almost all of the mFIs provide credit, a large number of them also mobilise savings from their clientele of developmental and credit programmes. It is also observed that there are many NGO-mFIs working with less than one thousand households and may have no immediate plans or capacity to expand operations significantly. As against these, a few mFIs plan to work with even 50,000 families or so in the next 3 to 4 years and provide financial services to them. Evidently, such large mFIs cannot be compared with the smaller mFIs. The Task Force is, therefore, of the opinion that there should be a dividing line between "small" and "large" mFIs from the point of view of their operations, and more particularly mobilisation of savings by them, as safety of the interests of the small savers is involved. The cut-off limit will also determine the extent of regulation and supervision requirements for the mFIs. In deciding the cut-off level of business, the Task Force was guided by the following considerations :

1. the average level of business of the majority mFIs,
2. a reasonable level so as not to have too many small mFIs reporting to national level authority, and
3. safety of the savers.

3.9.2. The Task Force has examined data from more than 350 agencies which have availed of assistance from RMK, FWWB and NABARD for their microfinance activities. It was found that almost 90% of the mFIs have their outstanding loan business at less than Rs. 20 lakh. Further, almost 50% of them have a client base of less than 1,000. As savings mobilised by these mFIs generally do not exceed their loan business, it can be reasonably assumed that the extent of savings mobilised by them would at best be equal to their loans. It has also been observed during the course of field studies of SHGs and other types of ground level microfinance structures that individual thrift per month generally does not exceed Rs. 50 and an mFI operating in a small geographical area and serving about 1,000 clients would require about five years to mobilise a level of aggregate savings of about Rs. 25 lakh. The Task Force, therefore, considers that the cut-off level of business for the purpose of regulation and supervision by a regional or a national authority may be savings from the clients of the mFI and fixed at aggregate savings of Rs. 25 lakh, for the present .

3.10. mFIs Purveying Credit only

3.10.1. The Task Force has deliberated over the issue of legitimacy of NGO-mFIs undertaking lending operations through a combination of their own resources, grants and loans taken for onlending. It is of the view that there need not be any elaborate regulation for the mFIs purveying credit only and not mobilising savings in any manner. Once the initial registration is done, the agencies may furnish only periodic (half- yearly) statements providing details of their financial operations.

3.10.2. Most mFIs having outstanding loan business of a high order would normally have borrowings from banks, development financial institutions, or other agencies for the purpose of onlending. Such mFIs will in any case be monitored by the lending agencies as part of their ordinary business as lenders. However, in the interest of the organisational development of the mFI, some other form of regulation will also be necessary. Such mFIs will have to comply with suitable prudential accounting norms relating to income recognition, asset classification and provisioning. This type of regulation is considered necessary especially for such mFIs not only for ensuring healthy loan portfolio but also for enhancing their credibility with the financing institutions.

3.10.3. In the ordinary course, regulation for these mFIs will be, to a great extent, through the auditors. The auditors may be required to check the microfinance activities of the agencies carefully and report about their performance in a prescribed manner. They may be required to submit a special report confirming that the agency has got registered with the competent authority or has applied for that, and is not actually mobilising any savings. In the event of violation, the auditors may report directly to the competent authority.

3.11. mFIs Mobilising Savings and Purveying Credit

3.11.1. As indicated in chapter 2, a large number of NGOs mobilise thrift (savings) from their loanees or clients as part of their programme for serving the poor. The Task Force has discussed the implications of mobilisation of savings by the NGOs and SHGs' federations with reference to the provisions of the RBI Act, 1934. As per the amended Section 45 S of the Act ibid,

"No person being an individual, or a firm or an unincorporated association of individuals shall accept any deposit if :

his or its business wholly or partly includes any of the activities specified in clause (c) of Sec. 45-I (i.e., the business of a financial institution such as financing activities of other institutions, acquisition of shares, bonds, debentures, etc., letting or delivering of any goods under hire purchase agreements, insurance business, managing chits and kuris and collecting money by issue of units), or

his or its principal business is that of receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner".

3.11.2. This raises a question about the appropriateness of NGO-mFIs mobilising thrift and savings from their clients /loanees. Such agencies may broadly be classified under the following categories :

1. SHGs' Federations acting as balancing centres very often accept surplus resources of one SHG for on-lending to another SHG;

2. NGOs replicating Grameen model mobilise small savings from the individual members of the groups which add to the resource base for loaning among the client-members; and

3. NGOs implementing various savings and credit schemes accept thrift /savings from their clients. Credit Unions in Kerala and Tamil Nadu and `Jeevan Deep Scheme' of Ramkrishna Mission Lok Shiksha Parishad, West Bengal are a few of such cases.

3.11.3. It is often contended that the principal business of the NGOs is not that of a financial institution, as these institutions are basically engaged in socio-economic upliftment of the poor. The Task Force has examined the issue at length and has observed that many NGO-mFIs are mobilising savings from their client-borrowers or beneficiaries of their social sector interventions with the sole objective of inculcating a habit of thrift and savings among their poor clientele and for enabling the use of such resources for acquisition of assets or linkage with credit off-take from the mFIs or banks.

3.11.4. Experience from the SHG bank linkage programme has shown that the rural poor save by foregoing their consumption needs and such small amounts of thrift can trigger investment in unconventional activities which in turn acts as the starting point for their economic upliftment

and integration with the economic mainstream. This potential has been recognised by the NGO-mFIs which provide the services of safekeeping of the thrift amount of the clients through innovative savings products. Due to various reasons, the formal banking sector has not been able to provide a suitable savings product or mechanism to tap such thrift which are also at times in non-cash mode, as these were not considered cost effective. Providing cost effective savings service also becomes difficult where the bank branches are serving a large number of villages. Savings, therefore, form part of the overall integrated package of financial and non-financial services by the NGO-mFIs. While relevance of flexible and timely credit to the poor by the NGOs has been recognised by GOI, RBI and the banking system, provision of savings services can not be viewed in isolation.

3.11.5. The Task Force is convinced that these NGO-mFIs are providing very useful financial services to the poor including the opportunity to keep their very small savings safe and almost at their own doorstep. Many of these NGO-mFIs have been mobilising such savings even before the amendment to Section 45 S of the RBI Act. In the present scenario, the available mode of institutional arrangement could be either a cooperative society or an NBFC, besides a bank. There are, however, certain inherent institutional constraints in these NGO-mFIs coverting themselves into cooperatives or NBFCs. These are :

1. absence of enabling provision to transfer the assets and liabilities of the NGOs to any non-NGO structure;
2. financial services provided as an add-on activity incidental to main developmental activities of charitable nature and therefore practically unseparable from the core activities of the NGOs;
3. high capital requirement for setting up of NBFCs; and
4. the cooperative institutional arrangement, could lend itself to vitiated managements which do not ensure exclusive focus on the poor.

3.11.6. In the circumstances, denial of such savings services to these poor, especially women, on account of technicalities in the institutional framework of the NGO-mFIs would have the effect of the clientele of the mFI being by-passed by both the banking system and the NGO-mFIs. The Task Force is of the view that the NGOs may be treated as body corporate for the limited purpose of Sec. 45 S of the RBI Act and may be allowed to mobilise savings only from their clientele as part of the financial services provided to them. It feels that the intention behind the amendment to Sec. 45 S might not have been denial of such services to the poor. However, proper regulation and supervision of the activities will not only bring in orderly growth of these agencies but also ensure safety of the interests of the small savers. Incidentally, the Task Force has observed with interest the views of the Governor, RBI to the effect that the most appropriate way to meet the credit needs of the poor women may be by encouraging SHGs and microcredit organisations.

3.11.7. Having considered savings as one the essential financial services provided by the NGO-mFIs, the Task Force observes that, as a first step, all mFIs under these categories will also register themselves with the appropriate registration authority, as indicated in para 3.7 above. If such institutions mobilise savings in excess of the cut-off limit, they may have to register also with the central authority at the national level. Further, in respect of the NGO-mFIs mobilising savings or deposits from people other than clients (including those under social sector interventions), the RBI will have to take a view.

3.11.8. As regards regulations, the Task Force feels that these institutions will have to be treated on different considerations from the ones not mobilising savings. In this context, it was also deliberated whether there is need for elaborate regulation in respect of NGO-mFIs mobilising

very small quantum of savings from their clients. It was felt that initially after the introduction of their saving schemes, NGOs would need some time and experience to stablise their services, during which time they may find difficulty in complying with elaborate regulations. The Task Force is of the view that for the present, those NGO-mFIs mobilising savings not exceeding Rs.2 lakh at any point of time may be excluded from the regulatory norms proposed below. However, such NGO-mFIs will have to obtain registration and submit periodic information to the competent authority. In respect of other NGO-mFIs mobilising savings from their clients above the level of Rs.2 lakh, the following regulatory norms would be applicable.

3.11.9. For those mFIs mobilising savings above Rs.2 lakh and below the cut-off level, the regulation may comprise a minimum reserve of 10 % of the savings as at the end of the second preceding quarter. The mFIs may be asked to maintain the reserve in the form of deposits with any scheduled bank in any manner and forward specified quarterly statements to the registration authority. In respect of the mFIs having savings above the cut-off level, the reserve requirements may be 15 % of the savings to be maintained in the form of bank deposits. Further, these mFIs may be required to comply with prudential norms regarding income recognition, asset classification and provisioning.

3.11.10. While dealing on the issue of the safety of the savings, the Task Force also pondered over the issue of insurance of such savings. As indicated in para 2.20.2 of chapter 2, almost entire deposits in the formal sector are at present covered by the insurance of DICGC. The mFIs deploy their mobilised savings generally in the form of loans to their clients who may be savers also. Since mFIs have generally registered very high repayment rates in the past, there may not be any apprehension about these loans. But, as a matter of abundant caution and prudent business policy, the Task Force recommends that the DICGC may work out suitable deposit insurance schemes for the savers of the NGO-mFIs on payment of some reasonable premium by them. If necessary, suitable amendments may be made to the respective Acts for facilitating such schemes.

3.12. Prudential Norms

3.12.1. In conformity with the internationally-accepted "Basle Norms", the financial sector in the country has been subjected to certain prudential norms. Beginning with the commercial banks in early nineties, RRBs, cooperative banks and financial institutions including NBFCs have generally been advised by the RBI to comply with specified prudential norms. The standards of various components of these norms, viz., capital adequacy, income recognition, asset classification and provisioning are being gradually raised over the years to make them at par with internationally acceptable levels for such institutions. The need and relevance of these norms for financial institutions of any type cannot be over-emphasised for ensuring their transparency, profitability and sustainability. The Task Force is of the view that if the mFIs are to be included in the financial sector, they will have to be subjected to a minimum form of prudential regulations so that other institutions dealing with them would have greater confidence about their sustainability. However, the type and extent of these norms would have to vary depending upon the category of NGO-mFIs.

3.12.2. The Task Force feels that mFIs not mobilising savings may not be subjected to any specified prudential norms provided they comply with the registration, auditing, and other reporting systems and also do not avail any loans for carrying out their lending activities. However, if such an institution takes loans (from banks or any financial institution) it will have to comply with specific prudential accounting norms regarding income recognition, asset

classification and provisioning for ensuring sustainability of its operations as also maintaining proper financial discipline. Regarding the mFIs mobilising savings above the prescribed cut-off limit, the Task Force is of the view that a different set of norms is necessary. Such norms may include increased reserve requirements besides proper income recognition, asset classification and some provisioning on the lines mentioned above. The Task Force recommends that the prudential accounting norms may be laid down by the RBI, if necessary, in consultation with NABARD and other agencies.

3.12.3. In respect of the mFIs which accept savings from both their loanees / clients and public, the Task Force observed that as per the existing instructions of RBI, such institutions may have to transform themselves as banks (including local area banks) or NBFCs and all usual norms and guidelines as are applicable to such institutions may be made applicable to them. The Task Force does not consider it prudent to recommend any relaxation in regulations, viz., net owned funds, reserve requirements and prudential norms for the mFIs mobilising savings from the public even if such institutions are (also) providing credit to the poor. The broader consideration is the safety of the savings of the public and from that point of view, the applicability of all usual regulations is well justified.

3.13. Role of Auditors

3.13.1. The Task Force has deliberated over the issue as to how to determine whether a particular mFI has registered with the competent authority or whether it has applied for registration with central authority once it has reached the deposit level of Rs. 25 lakh. It feels that if an mFI registered under the Societies Registration Act or the Trusts Act undertakes financial intermediation, it ought to have a responsibility to disclose this in a reasonable time. The Task Force has examined a comparable situation in the case of NBFCs where the RBI has resorted to reporting by statutory auditors and feels it appropriate to place reliance on the statutory auditors of the societies in this regard. It is suggested that the auditors may, in respect of mFIs, file a special report alongwith its audit report certifying / indicating the following aspects :

1. whether the agency has registered its financial intermediation or microfinance activity;
2. the extent of savings mobilised by the mFI from the clients / loanees, public, (no. of savers, amount and nature of savings);
3. the extent of credit provided (no. of borrowers and maximum outstanding during the year); and
4. in case the savings mobilised exceed Rs.25 lakh (prescribed cut-off limit) at any time during the year, whether the institution has applied for registration with the national authority.

3.13.2. The Task Force recommends that GOI may issue instructions to the state governments to direct the Registrars of Societies for passing appropriate instructions in this regard. In addition, GOI may ask the Association of Chartered Accountants of India to advise its members suitably in the matter. In the event of violation of the above instructions by mFIs, the statutory auditors may file a direct report to the competent authority. Non - reporting by the auditors may also have to be taken seriously by the Regulatory authority.

3.13.3. The Task Force has observed that in the case of banks, panels of auditors are prepared by the Institute of Chartered Accountants every year in consultation with RBI. Having regard to the special features of microfinance operations, it may be a worthwhile proposition to prepare

similar specialised panel of auditors for NGO-mFIs. Accordingly, the Task Force recommends that RBI may initiate necessary action in this regard.

3.14. Rating of Savings Schemes

3.14.1. The Task Force has deliberated on the need for rating of savings products of the mFIs. As discussed in chapter 2, it observed that the savings products of the mFIs comprise both voluntary and compulsory ones. Further, they are in the nature of time (recurring) deposits and generally not withdrawable in the short term. Some of savings is really in the nature of capital funds. As the NGOs do not have share capital like the other organisational forms, these are treated as resources. The Task Force compared the mobilisation of savings by mFIs with those of NBFCs accepting deposits and found that the same are broadly comparable. Incidentally, it may be mentioned that at present, the maximum period of NBFC deposits is 5 years. The Task Force, however, feels that the saver should have some freedom to utilise the funds as per his/her choice, that is to say, a saver should have access to the savings at any time, be able to take loan against it, or lodge it as down-payment for a larger loan. Accordingly, it recommends that the mFIs will take care, in particular, to ensure that the savings mobilised by them from their clients :

1. are withdrawable as per the discretion of the saver; and
2. are kept with the mFIs for a period not exceeding 5 years.

3.14.2. In the financial sector, except banks, it is mandatory for any institution desirous of mobilising deposits from the public, to secure rating of the savings product from accredited rating agencies. In respect of the NGO-mFIs, since the entire savings are mobilised from the clients and more particularly, from the existing loanees, the requirement of such ratings may not be insisted upon provided the amount of savings mobilised is less than the cut-off level. However, in case any NGO-mFI mobilises savings in excess of the cut-off level of savings, the mFI may also go for rating by any accredited agency. Although the poor savers may not understand the implications of rating of their savings with the NGO-mFI concerned, such a rating may help build public confidence.

3.15. Supervision

3.15.1. At present, NBFCs and credit cooperatives are supervised by the RBI and the Registrar of Coopertive Societies of the respective states. MACS are required to be supervised by the Registrar of MACS. However, NGO-mFIs are not subjected to any kind of supervision by a competent authority in the financial sector. As stated earlier, this need had not arisen as these agencies were not considered part of the financial system. With the accession of this sector as a part of the financial sector for providing financial services to the poor, there is a need for the supervision of the mFIs in view of the following reasons :

1. protection of the interests of the savers and the borrowers;
2. orderly growth of the microfinance sector; and
3. parity with other institutions in the mF sector.

3.15.2. The Task Force observes that in the context of the implementation of financial sector reforms and gradual liberalisation of the economy, the creation of an effective and efficient supervision machinery has been given critical importance and on-site inspection and off-site supervision has been adopted for banks for evaluating their performance under 'CAMELS' system encompassing Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Systems and Compliance. The Task Force is of the view that as NGO-mFIs are expected to play a greater role in the rural economy and as these agencies are likely to deal with other agencies in the financial sector, their supervision right from the beginning has also to be on similar basis, even though the norms and parameters need not be as stringent as in the case of banks and financial institutions. Further, as in the case of regulation, the coverage and frequency of supervision may vary depending upon the type and range of services provided by the mFIs. The Task Force feels that a system of off-site supervision may be generally adequate for the mFIs :

1. not mobilsing savings and not availing bank loan for credit operations;
2. mobilising savings upto Rs.2 lakh and not availing bank loan for credit operations

However, in the case of other categories, both off-site supervision and inspection may be necessary. On-site inspection may have to be made compulsory for issuance of the registration number by the competent authority.

3.15.3. As regards the scope of supervision, the Task Force is of the opinion that asset quality, management and systems should be given primary importance. Both on-site inspection and off-site supervision should bring out clearly the quality of the loans and their impact as also the composition of the clientele. For the purpose of off-site supervision, a few simple statements and returns may be prescribed.

3.15.4. The periodicity of the inspection will vary depending upon the type of mFIs. For mFIs undertaking only credit activities and availing bank loan, inspection may be done once in 3 years. In respect of mFIs mobilising savings above Rs.2 lakh, the periodicity of inspection may be once in 2 years.

3.16. Competent Authority for Regulation and Supervision

3.16.1. The regulation and supervision of the NGO-mFIs would comprise :

1. registration of all NGO-mFIs undertaking financial services at regional/state level;
2. receipt of periodic information and overseeing the trend and progress of microfinance;
3. registration of NGO-mFIs mobilising savings in excess of the cut-off level with the national level authority;
4. regulation of all NGO-mFIs; and
5. supervision of all NGO-mFIs.

3.16.2. Considering the importance of the regulation and supervision in the growth of the microfinance sector, the Task Force feels that the RBI may have to set up a special arrangement to regulate and supervise the activities of the NGO-mFIs. In this regard, the Task Force does not have any hesitation to suggest that the SROs would have been the best agency, at least as regional level regulator. However, till the time such SROs develop at the regional level, or such

SROs wherever developed are recognised by the RBI, the Regional offices of the RBI or a body designated by RBI for such purpose, will have to take up the regulation and supervision of NGO- mFIs. As and when SROs develop at the regional level and are found suitable by RBI, they can take up the job and report periodically to RBI.

3.16.3. At the national level, the overall regulation and supervision of NGO-mFIs will have to remain with RBI. The Task Force observes that at present there is no legal enactment which can take care of the requirements for regulation and supervision of NGO-mFIs. The RBI Act, 1934 does not also recognise the financial activities of the NGO-mFIs as a class. Also, Banking Regulation Act, 1949 is totally silent about the concept of microfinance and mF institutions. There may, therefore, be a need for suitable amendments to the RBI Act and the B.R. Act to respond to the emerging developments of the microfinance sector.

3.16.4. The regulation and supervision arrangements proposed and recommended in this chapter mainly relate to NGO-mFIs which are set up under Societies Registration Act, 1860, or analogous state Acts, or Indian Trust Act, 1882. Other institutions coming within the fold of mFI as described in para 2.3 of chapter 2 will continue to be regulated as hitherto.

3.16.5. The Task Force observes in this regard that certain mFIs have been registered as "Section 25" companies for providing financial services exclusively to their poor client-members. The justification of prescribing regulatory norms for such mFIs was examined by the Task Force. It is observed that from the point of regulation what is relevant is the safety of the savings, sound functioning of the institution and quality of their loans. Since these institutions are comparable with NGOs as regards non-distribution of profit, the Task Force feels that these companies may be subjected to the same regulatory norms as would be applicable to the NGO-mFIs mobilising savings.

3.17. Regulation and Supervision Costs

3.17.1. In the absence of a regulatory framework, at present there is no cost being incurred by any agency for regulation of the NGO- mFIs. But, if a regulatory mechanism for the mFIs is to be set up, there would be costs both for regional or state as well as national level set-up. If the set-up is not wholly under RBI, and is to be managed very largely by SROs at the regional or state levels, direct costs will have to be met. Assuming that a small complement of five personnel of various cadres are engaged in a regional set-up, the cost per regional level body would work out approximately to at least Rs.10 lakh per annum. Depending upon the number of such set-ups, the cost per annum for the whole country would be in the region of Rs.1.5 crore to Rs. 2.0 crore. In addition, direct supervision cost of the mFIs by RBI or a designated agency may cost another Rs.20 lakh or so. The Task Force recommends that as part of the overall financial sector, the regulation and supervision costs will have to be borne by the RBI.

3.18. Highlights of the Chapter

1. *Savers with mFIs usually clients of their welfare programmes or present / future borrowers, but legally not 'members' of the mFIs. Need for regulation and supervision to protect the savings of the poor deposited with mFI*

2. *Credit activities of mFIs also need to have financial discipline. A data -base on activities of mFIs also need to be created.*

3. *SROs seem to be best suited for regulation of mFIs.*
4. ***SRO's functions will include***

- *Acting as base level regulator*

- *Registering mFIs*
- *Setting performance standards*
- *Evolving accounting/ systems for MFIs*
- *Conducting audit and inspection of mFIs*
- *Representing mFIs in different Fora*

1. ***Structure of SRO***

- *Should have minimum 50 mFIs (relaxation during 3 year lead time to be provided) vi.* ***Recognition of SRO***
- *RBI to recognise*
- *RBI Act to be amended to include mF, mFIs and SROs*
- *NABARD, SIDBI, RMK and commercial banks to assist development of SROs*
- *RBI to constitute a Working Group of associated institutions*

vii. But regulation of mFI need to be started immediately without waiting for evolution of SROs. There are several limitations in straightway involving SRO due to

- *Quality of information with most mFIs being poor;*
- *Too few associations of mFIs at the moment;*
- *Not all mFIs are members of such associations;*
- *Technical competence of such associations needs to built up; and*
- *Minimum performance standards yet to be developed. viii.* ***Regulation*** *(a)* ***Registration of MFIs***
- *All NGOs acting/wishing to act as mFI to register with Regional/ National Authority;*
- *mFI with savings above a cut-off level to register with RBI (National Authority);*
- *One year lead time to be given to all existing mFIs to decide their future course;*
- *RBI to decide separately on NGOs providing financial services to non-poor; and*
- *All donors, banks and FIs to ensure authentic registration of mFI before assisting.*

*(b****) Classification of mFIs***

1. *Purveying only credit*
2. *Credit plus savings from clients (aggregate savings below cut-off level)*

3. *Credit plus savings from clients (aggregate savings above cut-off level)*
4. *Credit plus savings from clients and others (Public) (c)* ***Cut-off level of business***
    - *For the present, savings of Rs.25 lakh at any point of time in a year.*

(d) ***Limitations on NGO-mFIs mobilising savings***

- *As clients of welfare programmes or borrowers are legally not `members' of Societies, savings even from clients could be construed as savings from public and violating Section 45 S of the RBI Act.*
- *NGOs registered as Societies/Trusts do not have capital to help them leverage loanable funds.*
- *Savings constitute an inseparable function of their mF activity.*
- *Though NGOs can float NBFCs to legalise savings from clients, their resources to other institutions (NBFCs) cannot be passed even though the latter are promoted by them (through their main functionaries).*
- *Turning client base into a cooperative society may lead the organisation to politicisation and mismanagement.*
- *Hence, for small NGO-MFIs their present organisational status needs to be retained.*

(e) ***Regulation for NGO-mFIs.***

Type of NGO- mFIs	***Norms recommended***
For credit only mFIs, without bank loan	*Submission of statements to designated authorities. - special reports by Auditors*
For credit only mFIs with bank loan	*As above plus prudential norms*
For mFIs with the savings upto Rs.2 lakh and without bank loan	*Submission of statements to designated authorities. - special reports by Auditors*
For mFIs with the savings > Rs. 2 lakh </= Rs. 25 lakh	*As above plus minimum 10% reserve as bank deposit*
For mFIs with the savings > Rs. 25 lakh	*All above including prudential norms plus minimum 15% reserve as bank deposit plus registration with RBI*

- *Other mFIs [non-NGO] to be regulated as per existing arrangements*

ix. ***Role of Auditors***

- *To file a special report covering the following:*

    1. *Whether the agency has registered its financial intermediation or microfinance activity;*
    2. *The extent of savings mobilised;*
    3. *The extent of credit provided ; and*
    4. *In case the savings mobilised exceed Rs.25 lakh at any time during the year, whether registered with RBI*

- *RBI to initiate action for preparing a specialised panel of auditors for mFIs*

- *Rating of savings scheme for mFIs having savings in excess of Rs.25 lakh*

x. ***Supervision***

- *Off-site supervision only for*

  mFIs not mobilising savings and not availing bank loan

  mFIs mobilising savings upto Rs. 2 lakh and not availing bank loan

- *For others - both inspection and supervision- periodicity 2 or 3 years*

xi. ***Competent Authority***

- *At the regional / state level - Regional Offices of RBI or institutions designated by RBI/SROs*
- *At the national level - Reserve Bank of India*

Need for amendment to RBI Act to institute the above regulations /mechanisms