Doing Business Of Microfinance In India

Equi Corp Associates, Advocates & Solicitors

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Microfinance: An Introduction

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Microfinance is a form of financial services for entrepreneurs and small business, which lacks traditional banking services. Microfinance in India is gaining momentum for sustainable development and financial inclusion. This sector in India is currently undergoing into huge innovations and claiming to be an emerging sector especially in creation of financial inclusion for grassroot.

Microfinance Institutions (MFIs) has proven to be an important liberating force in societies where grassroot people in particular have to struggle against repressive social and economic conditions, who are otherwise excluded from the formal channel of credit. Economic growth and political democracy cannot achieve their full potential unless the person standing on the last strata of the society participates on an equal footing with the society.

There are many innovative initiatives have been undertaken by Indian MFIs over the past five to seven years and they have expanded manifold to provide financial services to low-income clients with the objectives of providing financial services to large numbers of low-income clients, and ensuring long-term sustainability.

Role & Significance of Microfinance

Micro-finance contributes to social and economic development of India in the following ways:

1. *Poor people cannot access banking services due to their meagre income and inability to handle banking procedures and documentation. It is through micro-finance that a wide range of financial services such as deposits, loans, payment services, money transfers and insurance can be provided to the poor and low-income households and their micro-enterprises.*

2. *MFIs through NGOs, develop saving habits among poor people. The financial resources generated through savings and micro credit obtained from banks are utilized to provide loans and advances to the members of the Self-Help Groups (SHGs). Thus, MFIs help in mobilizations of savings and using the same for the welfare of its members.*

3. *Loans from the normal banking system require collateral or counter guarantee which poor people cannot offer and therefore, cannot get loan. Again, high interest rates and procedural and documentation formalities act as a deterrent to poor people accessing banks for loans. Microfinance does away with all these obstacles and provides finance to rural and poor population on easy terms.*

4. *Micro-finance allows the poorer sections of the society to get loan at cheaper rates which helps them to start their business on a small scale, grow their business and get out of poverty and be independent and self-sufficient. It helps in creating long term financial independence among the poorer sections of the society and therefore, promotes self-sufficiency among them.*

5. *Micro- finance is provided through the intermediation of Self Help Groups (SHGs). More than 50% of the Self-Help Groups (SHGs) are formed by women. It is a step towards greater security for women. Thus, micro-finance empowers poor women economically and socially.*

Models of Microfinance

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1. ***Grameen Model- It is one of the successful model of microfinance. The model initiated through a group of five members. A compulsory contribution will made to group savings and insurance fund. Each member maintains their individual savings and loan account in the bank after contributing to the group, the members will receive individual loan from the bank. The responsibility of repayment lies on the individual. Loans are provided for a period of 6 months to 1 year and the repayment has to be made weekly. A period visit is conducted by the bank officials to monitor the records and the financial transactions. This model is being adopted in 40 countries in Asia, Africa and Latin America.***
2. ***Joint Liability Group Model- The members in this group are from 4 to 10 who form a group. The group members can avail bank loan against mutual guarantee and there is no condition of their own saving fund. All members jointly are in a contract making jointly liable for repayment of loans taken by all members. This model is followed in many microfinance enterprises in India. Many countries around the world follow this model.***

Models of Microfinance contd.

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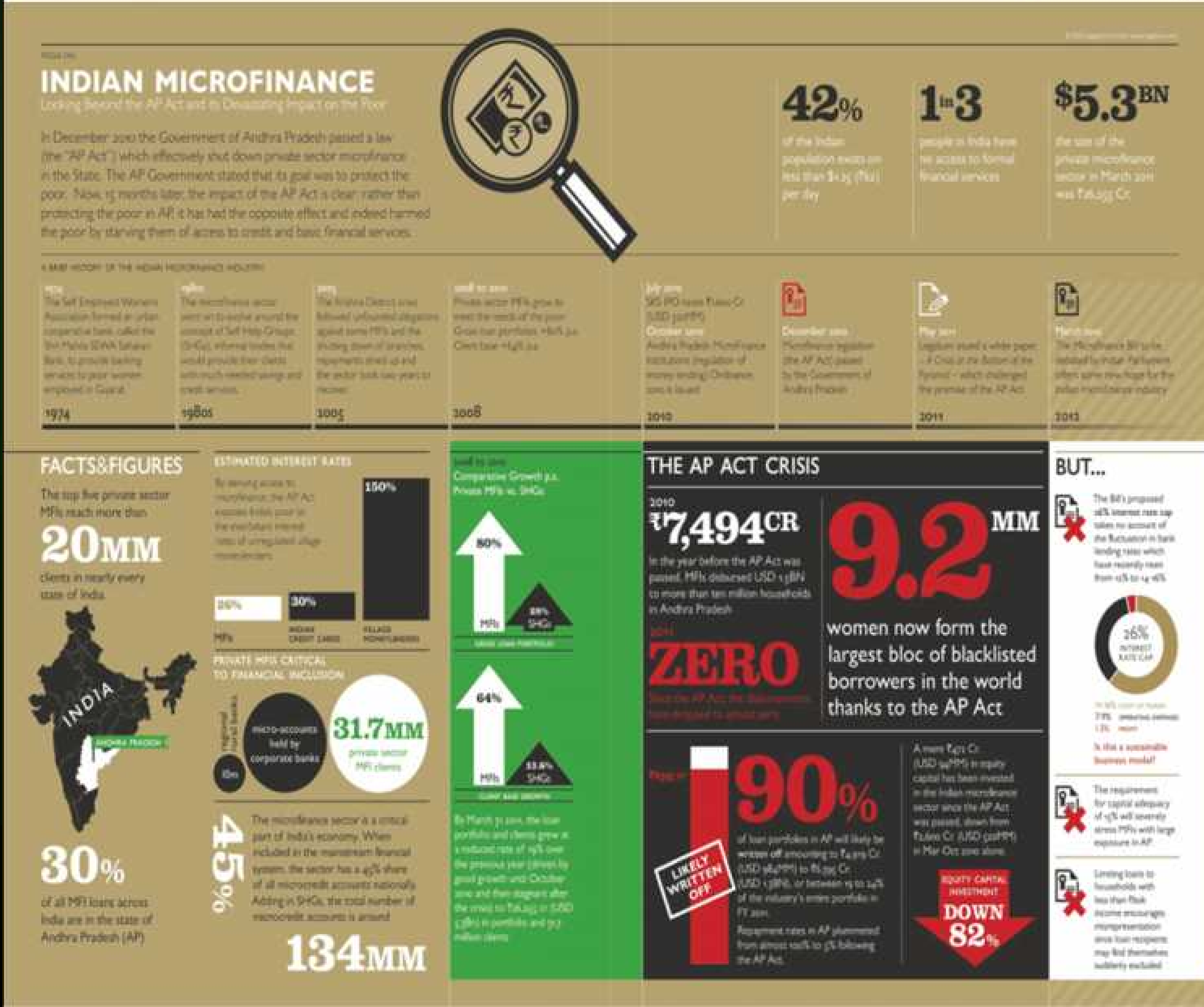
3. Individual lending Model- The individual can get loans by themselves without being affiliated in group. Financial Institutions have to closely monitor the status of borrowings. It is most successful for larger, urban-based, production-based business. This model is used in many developing countries such as Egypt, Indonesia, India.
4. The Group Approach- The entire financial process in group approach is monitored by financial institutions. The activities such as savings, loans, repayments are managed at group level. There may be 10-20 members who will have regular savings which will be pooled up as common fund. The loans are issued by financial institutions in the name of the group. The repayment schedule is made by the MFI to the group and field staff periodically visit and monitor the process of repayment. In India this method is known as SHG Bank Linkage Programme which is a very popular model being followed.
5. Self Help Group Mode- This SHGs are informal and homogenous groups of 10 to 20 members each. These groups are formed by bank officials, NGOs and other institutions at the village level. The group is given a name and each group has a leader, cashier and secretary being elected by the group members to manage the group affairs. The members indulge in voluntary savings on regular basis. The group members decide mutually on the amount of savings to be deposited in the group account. These amounts are used for rotational internal loan on low interest basis.

Journey of Microfinance



2014- The RBI issued universal banking license to Bandhan Bank, the largest microlender in terms of assets. Microfinance Institutes Network was formally recognized by the RBI as Self-Regulatory Organization (SRO)

2015- The Government launched MUDRA Bank to help and finance small business. 8 MFIs granted SFB licenses by RBI.

Journey of Microfinance contd.

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With the crisis in Andhra Pradesh in 2010 has made the whole microfinance industry into a down turn due to over indebtedness which paved the way to form Malegam Committee by Reserve Bank of India which gave recommended regulations lead to draft Bill-Microfinance Institutions (Development and Regulation) Bill 2011 which provides regulatory structure for microfinance institutions. Some of the silent features of the Bill:

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

Legal Structure of MFIs in India

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Legal Forms of MFIs		
Category	Type of MFIs	Applicable Law
Not for Profit	NGO MFIs (Societies & Trust)	Societies Registration Act, 1860 and/or Indian Trust Act, 1882
	Section 8 Company	Companies Act, 2013
For Mutual Benefit	Co-operatives	State Co-operative Societies Act or Multi-State Co-operative Societies Act, 2002
For Profit	NBFC	Companies Act, 2013 and registered with RBI

The Indian microfinance sector witnessed rapid growth over last decade. A microfinance institution acquires permission to lend through registration. Each legal structure has different formation requirements & privileges. Microfinance institutions in India are registered as one of the following entities:

1. *Non Government Organizations engaged in microfinance (NGO-MFIs) comprised of societies and trust*
2. *Cooperatives registered under the conventional State-Level Cooperative Acts or Multi-State Co-operative Societies Act 2002*
3. *Section 8 Companies (Not for Profit)*
4. *For Profit- Non banking Finance Companies (NBFCs)*

NGO- MFIs, Cooperatives and Section 8 Companies

Microfinance institutions operating as a non-profit company operate as either an NGO-MFI, Co-operatives or Section 8 Company. Each is structured slightly differently in terms of ability to accept equity investments and dividends. There exists little regulation that applies to these structures, aside from registration requirements.

Not-For Profit MFIs

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Societies Registration Act, 1860

(i) Name of the society is to be decided along with the draft memorandum and rules and regulations of the society that is to be formed.

(ii) Minimum of seven (subscribers) to sign each page and signatures to be approved by rubber stamp of a gazette officer or magistrate 1st class.

Other requisite documents need to be filled with Registrar of Societies for registration under the Principal Act or corresponding Acts enacted by various state governments:

(i) Covering letter requesting for registration along with list of documents attached signed by all the subscribers to the memorandum or by a person authorized by all of them to sign on their behalf.

(ii) Memorandum of Association in duplicate along with a certified copy.

(iii) Rules and regulations/bye-laws in duplicate duly signed.

(iv) Affidavit on non-judicial stamp paper of appropriate value sworn by the president or secretary of the society stating the relationship between the subscribers. The affidavit should be attested by an oath commissioner, notary public or magistrate1st class.

(v) Documentary proof such as house tax receipt, rent receipt in respect of premises shown as registered office of the society or no-objection certificate from the owner of the premises.

The governing body of the society will invest and funds and property of the society for the MFI business.

Not-For Profit MFIs contd.

Indian Trust Act, 1882

The essential constituents of a trust are

(i) three parties – the author, trustees and beneficiary;

(ii) declaration of a trust;

(iii) certainty of the subject matter of a trust; and

(iv) certainty of objects of the trust.

A charitable Trust is required to invest or deposit its funds in the modes or forms specified under Section 11(5) of the Income Tax Act. Besides, it must not hold any shares in a company (other than a government company or corporation). If any part of its funds is not so invested, the exemption under Section 11 would not be allowed.

Not-For-Profit Companies registered u/s 8 of the Companies Act, 2013

An organization given a license under Section 8 of the Companies Act 2013, is set-up for the promotion of microfinance facilities among the rural and urban population; and the constitution of such company provides for the application of funds or other income in promoting microfinance and prohibits payment of any dividend to its member.

MFIs For Profit

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Non-Banking Finance Company– Micro-Finance Institutions ("NBFC-MFI")

The mandatory requirements to be fulfilled to operate as an NBFC are as follows:-

(i) Should be registered as a company under the Companies Act, 2013

(ii) To obtain a certificate of registration from Reserve Bank of India ("RBI")

(iii) Have Net Owned Funds (NOF) – shareholder equity + internally-generated reserves of INR2 crores.

MFIs For Profit contd.

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If the MFI meets the above two criteria, it can file an application for registration with the RBI's Department of Non-Banking Services. RBI may, for the purpose of considering the application for registration, require to be satisfied by an inspection of the books of the non-banking financial company or otherwise that the following conditions are fulfilled:–

(i) that the NBFC is or shall be in a position to pay its present or future depositors in full as and when their claims accrue;

(ii) that the affairs of the NBFC are not being or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors;

(iii) that the general character of the management or the proposed management of the NBFC shall not be prejudicial to the public interest or the interest of its depositors;

(iv) that the NBFC has adequate capital structure and earning prospects;

(v) that the public interest shall be served by the grant of certificate of registration to the NBFC to commence or to carry on the business in India;

(vi) that the grant of certificate of registration shall not be prejudicial to the operation and consolidation of the financial sector consistent with monetary stability, economic growth and considering such other relevant factors which RBI may, by notification in the Official Gazette, specify; and

(vii) any other condition, fulfillment of which in the opinion of RBI, shall be necessary to ensure that the commencement of or carrying on of the business in India by a NBFC shall not be prejudicial to the public interest or in the interest of the depositors.

MFIs- Always a Profitable Business

You may be thinking, "Why would I invest in a group that is going to charge recipients money, when I could just donate to a charity?" Well microfinance is cool because if it is done right, the original money can help many more people than a charity donation would. The microfinance model is set up to be self-sufficient. Lets use the example of a Rs.1,00,000 contribution. Assume that both charities and microfinance organizations have a 20% administration cost. Also assume that each recipient must receive at least Rs.10,000. This means that 20% of the funds that get contributed, go towards paying costs of the organization. Therefore, in either case, the original Rs.1,00,000 contribution becomes Rs.80,000 of distributed funds. In the case of charity, the Rs.1,00,000 donation has just improved the lives of recipients by Rs.80,000. In total the Rs.1,00,000 has helped 8 people. Across the board, microloans have a payback rate of 90%. For example, if funds are distributed to 10 recipients, 9 of those recipients will pay back the loan. Now if that same microfinance group charges 30% interest, most of the money that is lost in administrative fees and loans that did not get paid back, is recouped by the interest.

MFIs is always a Profitable Business.. contd.

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Rs.1,00,000. Initial Capital of MFI

Rs. 80,000 remain as 20% is deducted as administrative fees

Rs. 80,000 X .90 = Rs. 72,000. Principle amount to be received back by Microfinance after 1st transaction cycle

Rs. 72,000 X .30= Rs. 21,600. Amount received as interest by the MFI 1st transaction cycle

Rs. 72,000 + Rs. 21,600= Rs. 93,600. Amount to be used again for MFI business.

Rs. 93,600 X .90= Rs. 84,240. Principle amount to be received back by Microfinance after 2nd transaction cycle

Rs. 84,240 X .30 = Rs. 25,272. Amount received as interest by the MFI 2nd transaction cycle

Rs.84,240 + Rs. 25,272 = Rs. 1,09,512. Amount to be used again for MFI business

After completion of 2nd transaction, MFI profit at 9.5%

Institutional Investors in MFIs

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- ***The market for institutional investors in microfinance is relatively new. Institutional investors are the fastest growing investment group in microfinance, having increased their outstanding investment in microfinance by 300%.***
- ***A diverse set of institutional players are dedicating investment resources to microfinance. Institutional investors include international banks, pension funds, venture capital funds, insurance companies etc. invest a huge chunk of their investment in microfinance, as the sector growth is more than 200% per annum.***
- ***Initially, many NGO MFIs were funded by donor support in the form of revolving funds and operating grants. In recent years, development finance institutions such as NABARD, SIDBI and microfinance promotion organizations such as the Rashtriya Mahila Kosh (RMK- the National Women's Fund) have provided bulk loans to MFIs. This has resulted in the MFIs becoming intermediaries between the largely public sector development FIs and retail borrowers consisting of groups of poor people or individual borrowers living in rural or urban slums.***

Launch of MUDRA Bank*: Micro Unit Development and Refinance Agency (MUDRA) was launched in April 2015 to fund and promote MFIs, which will in turn, provide loans to small business. The MUDRA scheme refinances collateral- free loans upto INR 1 million given by lending institutions to small, non-corporate borrowers, for income-generating activities in the non-farm segment. As of 2015, 8 of the MFIOs had been given the licenses for Small Finance Banks (SFB).*

MFIs as Partner to Banks

MFI can act as partner to commercial banks to provide services to customers on behalf of the bank. In this model, the customers do not engage directly with the bank, but rather with the MFI on a fee-for service basis. MFIs acting as agents for banks can offer the physical presence, experience and agility to reach low-income populations and assess them efficiently in the geographic locations, where the banks may not have a geographical presence. Due to higher administrative and infrastructure cost, the foreign and private banks may not be inclined to operate in rural areas, however, as per the direction of Reserve Bank of India, the banks had to disburse loan as microfinance, the partnership model of MFI with banks can be win-win situation for both of them.

Mobile Technology- A Boon for MFIs

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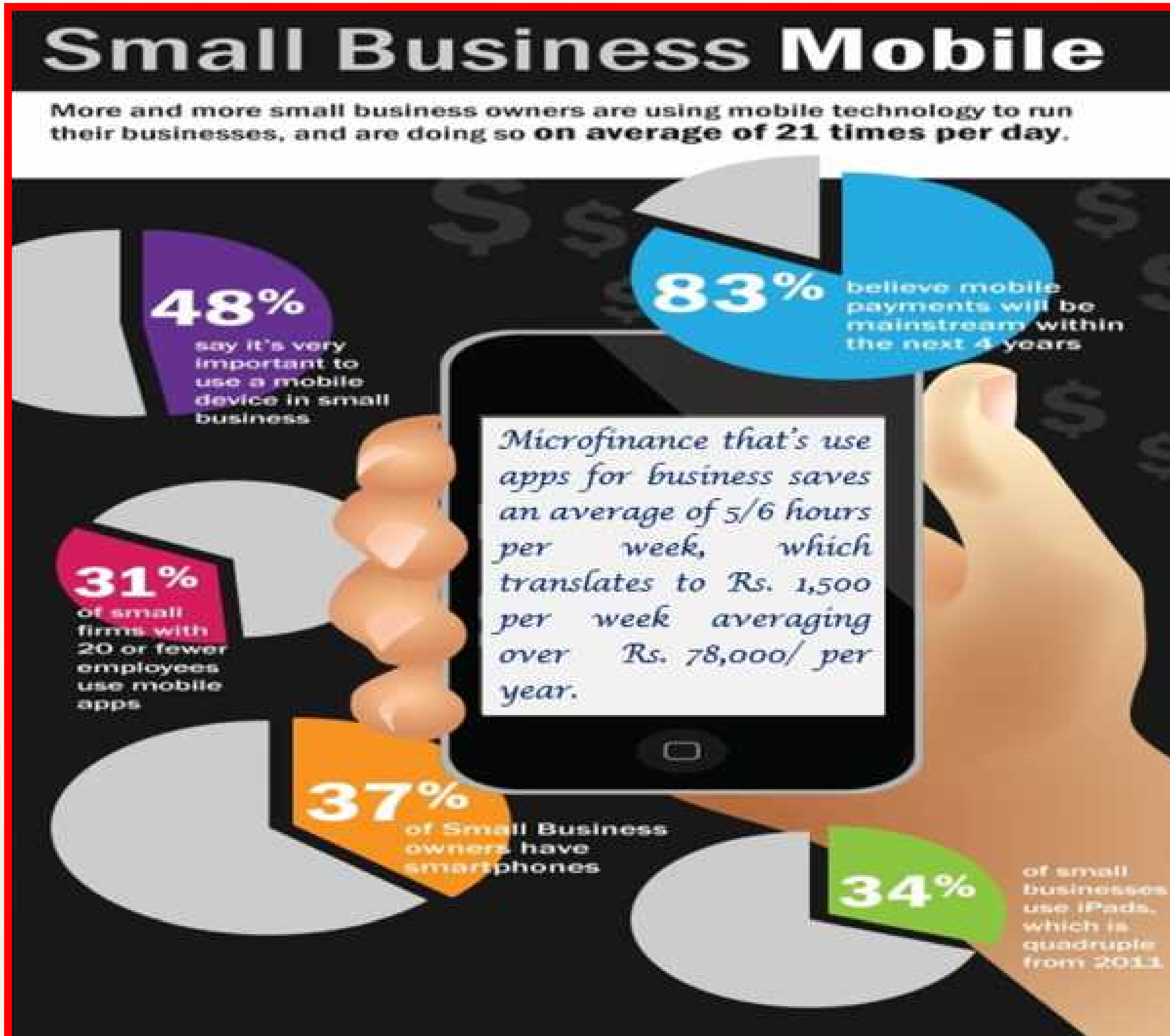
Mobile has a great potential to reach vast numbers of low-income, unbanked people at affordable prices with a wide range of products to meet complex financial needs. The mobiles can also be used as mode of communication with the customers of Microfinance and to be proven as great partners for spread of Microfinance business.



Growth of a MFIs' Business

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1. ***Foundation Stage-*** *A greenfield MFI is established, the license is obtained, initial capacities are developed and operations are launched. At this stage management consists largely of staff seconded from the technical partner or shareholder. The new MFI receives continuous training and capacity building from the technical partner. Ideally a local partnership is also established at this stage.*
2. ***Institutional Development Stage-*** *The branch network is gradually expanded, and operational breakeven is expected by the third or fourth year of operations. Expenses for technical assistance is maintained but reduced as local management and staff personnel have been trained and adequate systems have been rolled out.*
3. ***Sustainability and Further Advancement-*** *A second injection of capital is foreseen during the fifth or sixth year of operations to sustain the MFI's growth. Local staff now assume most managerial positions, and MFI absorbs the cost of senior staff, if applicable.*

Management of MFIs- Recent Trends

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The overall trend within MFIs in India is to move from an altruistic approach to a professional and sustainability-oriented approach. Some of the emerging ways through which MFIs are trying to achieve this are:

1. *More active boards: The governing boards of MFIs are becoming increasingly active not only in shaping institutional direction but also in ensuring that their directives are implemented through the board members' direct oversight of day-to-day operations.*
2. *Composition of the board: MFIs are now consciously trying to induct finance professionals and eminent practitioners as board members. Overall, this has the effect of injecting a professional culture into the organization and the microfinance sector as a whole. It also enhances the leveraging ability of the organization in relation to its external environment.*
3. *Separate organizations/divisions for undertaking different tasks. More and more multi-service organizations are moving towards the separation of microfinance divisions are moving towards the separation of microfinance divisions or even separate organizations for undertaking non-core activities. Thus, what has traditionally been called the "credit and savings programme" is now becoming an MFI in its own right to an independent microfinance profit centre.*
4. *Building external arrangements to leverage local knowledge and operating systems for generating revenue streams. A few MFIs are leveraging their local knowledge and networks to develop arrangements with large financial service providers for selling specialized products and services. Selling insurance products is a very good example of this trend. Other MFIs are trying to become agents of commercial banks, for onlending. Under this arrangement, the bank appoints the MFI as its agent who in turn does the lending for the bank and earns commission*

Evolving Base of MFIs

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- *Since its inception, the Indian MFI sector has been perceived as a predominantly rural- focused sector, however, recently MFIs have shifted their focus from rural hinterlands to urban pockets.*
- *The shift in the customer base of MFI has been due to several factors- strong growth of urban focused MFIs and reluctance of banks to lend to small borrowers. Many banks lend to small borrowers through MFIs in order to meet their priority sector lending targets in order to cut down operating costs and maximize operational efficiency.*
- *The rise in urban clients of MFIs also underlines reluctance of banks to lend to small borrowers. In spite of banking infrastructure in urban areas, there is a strong demand from the unorganized sector and migrants for microfinance loans.*
- *Priority sector lending is a government initiative which requires banks to allocate a percentage of their portfolios to invest in specified priority sector at a reduced interest rates. Currently only MFIs are designated as priority sector. The number of priority sectors has recently been reduced, which suggest that banks will rely more heavily on lending to microfinance institutions to meet the priority sector requirements.*

MFIs- Towards more Financial Inclusions

- ***MFI can join the national payment systems, gaining the use of ATMs and cards or POS devices to provide services through new channels.***
- ***To become business partners of international banks in rural areas for distribution of mandatory loans under direction of Reserve Bank of India for the rural areas.***
- ***To become an aggregator under PFRDA for collection of pensions funds.***
- ***Micro Insurance as additional line of business for MFIs- Insurance Regulation Development Authority (IRDA) allows any company registered under Companies Act 1956/2013 to become a corporate agent of the insurance company registered with IRDA. MFIs (NGO & for-profits) are allowed to become corporate agents of one life and/or non-life insurance company especially in rural and urban slum areas where insurance awareness is minimal and business opportunity is maximum in country like India.***

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➢Complete assistance for making the necessary filings, applications etc. for obtaining Govt. Authority /RBI's approval to operate as MFI.

➢Informal discussion with contact personnel within Govt. Authority/RBI so as to perfect the application before the same is submitted.

➢Follow up support at various points in time during and after the pendency of the application so as to ensure that any additional documents/records requested by Govt. Authority/RBI is submitted in a systematic and timely manner.

➢ To know the further details contact us at admin@equicorplegal.com

Our Presence

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