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Sharpening the Debate: Assessing the Key Constraints in Indian Micro Credit Regulation

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Contents

1 Introduction

Despite recent gains in India's micro credit sector, total financial inclusion is still a distant prospect. Over 80% of poor households in rural India have no access to formal financial services.[1] For those who can access these services, it takes an average of thirty-three weeks to get a single loan approved.[2] Inadequate regulation is one element curbing this sector's healthy expansion. Our goal in this paper is to identify the most commonly cited regulatory roadblocks to the growth of the sector, explain existing regulation in these areas, and determine whether or not different regulations need modification.

1.1 Transparency: The chief obstacle to consensus building

There are several regulatory distortions in the Indian microfinance sector. However, no distortion has such pervasive effects as the glaring lack of transparency. This transparency deficit lies at the heart of nearly all contentious issues in Indian microfinance regulation. Government officials base crucial decisions on reports which are kept hidden from public scrutiny. Some MFIs allegedly tinker with their non-performing loans to hide borrower defaults while others exclude "hidden charges" when disclosing interest rates. Because the market lacks *credible* information, stakeholders often suspect the worst of their counterparts. In turn, this suspicion spills over into suboptimal policy design.

Take, for example, the issue of borrower default rates. Central and state government officials assume that many MFIs conceal borrower over-indebtedness by rolling over bad debt. This assumption then fuels political support for interest rate caps so as to curtail lending to MFI borrowers and, therefore ease this borrower debt trap. However, if the 98% repayment rates, often advertised by Indian MFIs were perceived as credible, it would be much harder to justify rate caps as a protection against over-indebtedness. In this example, the lack of transparency in one regulatory arena has fueled contention in another. This paper will shed more light on the need to standardize and enforce MFI transparency norms. When MFI financials are credible, the scope for consensus-building on many regulatory issues will widen considerably.

[1] Y.S.P. Thorat. Microfinance in India: Sectoral Issues and Challenges. Theme Paper at the High Level Policy Conference for Microfinance in New Delhi, India. pp. 9. (2005)

[2] World Bank Country Profile: India (2005)

1.2 Limitations to the research: A study of Indian micro *credit* regulation

In addition to credit, the poor desperately need affordable savings and insurance products. There is growing evidence that these financial services are as important (if not more important) than access to cheap credit. India's existing regulatory frameworks are not equipped to deal with its fledgling micro savings and micro insurance sectors. To sharpen the focus, this paper will concentrate entirely on micro credit regulation. Because much has been written on micro credit regulation in India, rather than overlap with other comprehensive surveys, this paper will pinpoint only the key stumbling blocks in India's micro credit regulatory framework.[3]

2 Interest Rate Regulation

2.1 Existing Regulation

In a circular dated February 18, 2000, the RBI introduced a three-pronged regulatory reform package to stimulate commercial banking interest in India's micro credit sector.[4] This package introduced the following measures:

1. Interest rates on loans made by commercial banks to microfinance organizations were deregulated.
2. Interest rates on loans made by micro credit organizations to end borrowers were deregulated.
3. Micro credit extended by commercial banks either directly to end borrowers or through an intermediary was to be considered as part of banks' priority sector lending requirement.[5]

Commercial banking activity increased substantially in the wake of these reforms, led largely by ICICI Bank's heavy involvement in the sector. The RBI's Master Circular

[3] For those interested in a broader study of Indian microfinance regulation, the bibliography includes ample material for more in-depth reading.

[4] RBI's Circular on Micro Credit dated February 18, 2000.

[5] Direct banks loans below Rs. 200,000 to individual borrowers are still capped at the prime lending rate if these loans are to be included among the bank's priority sector lending requirement.

on Micro Credit dated July 3, 2006 underscored its commitment to leaving micro credit interest rates unregulated:

"The interest rate applicable to loans given by banks to micro-credit organisations or by the micro-credit organisations to Self Help Groups/member beneficiaries would be left to their discretion."[6]

Despite the RBI's laissez faire approach to micro credit regulation, the threat of formal rate caps at the state level persists.

2.2 State Level Regulation of Interest Rates

In 2003, the Tamil Nadu State Government introduced the *Tamil Nadu State Prohibition of Charging Exorbitant Interest Act No 37*. This capped money lending rates at 12% for unsecured loans even while SBI's short-term priority sector lending rate hovered around 8.75% in 2003.[7] This left a 3.25% spread between the cost of funds for an MFI and the proposed rate cap. Therefore, a Tamil Nadu MFI wishing to offer financial services, *without* external subsidies, would have to pay for all of its operating costs (salaries, transportation costs, loan document processing costs, bad debt provisioning, etc.) with this 3.25% spread. According to MixMarket (2005), only two MFIs in the world have operating costs below this level.[8] What's more, Spandana, the most operationally efficient MFI in India (fifth most efficient worldwide) has operating expenses amounting to roughly 4.22% of its loan portfolio. Therefore, if enforced, a 12% rate cap would push *all* non-subsidized MFIs out of the market.

Citing many of the above concerns, the Federation of Financiers Association-Namakkal filed an appeal against the 2003 Act. In June 2004, the Chennai High Court stayed the Act's provisions ordering district-level officials not to take action against MFIs charging in excess of the 12% cap.[9] However, the potential for state level rate regulation has not abated. The Government of Andhra Pradesh has hinted on multiple occasions that it may introduce a 12% rate cap on all micro credit lending. SBI's priority sector lending

[6]RBI Master Circular on Micro Credit, Section 4. (July 3, 3006)
[7]The Hindu Business Line. "SBI cuts rates for priority sector lending." (11/12/03)
[8]www.mixmarket.org. MFIs ranked by operating expense to loan portfolio ratio using 2004/5 data.
[9]The Hindu Business Line. "Madras HC stays TN law on exorbitant interest." (June 30, 2004)

rate currently stands at 8.5%,[10] once again leaving just a 3.5% spread to cover all MFI operational costs. In addition, the RBI raised key short term lending interest rates on July 25, 2006 and at 7%, these are as high as they have been in four years. Most commercial banks are expected to hike their prime lending rates even further following this recent step, thus narrowing the thin spread even further. In short, a 12% rate cap on the Andhra Pradesh's micro credit sector could lead to the sector becoming dependent on limited state and donor subsidies.

2.3 Policy Recommendations

2.3.1 Laissez faire regulation of interest rate levels

The international experience with micro credit interest rate caps is summarized nicely by CGAP: "Interest rates caps, where they are enforced, almost always hurt the poor-by limiting services-far more than they help the poor by lowering rates."[11] Priya Basu, Lead Economist for the World Bank in India, adds that "in the face of interest rate caps, most reputable private financiers tend to walk away from lending to these would-be clients, who are driven instead to borrow from moneylenders whose rates are not capped and whose collection rates are notorious."[12] Even with the rapid expansion of India's micro credit sector over the past decade, it is worth repeating that over 80% of poor households in rural India still have no access to formal financial services.[13] In a country with such a massive under-supply of financial services, levying rate caps on micro credit activities is irresponsible. Rather than formally regulating rate levels, the state should allow self-regulatory organizations (SROs), such as Sa-Dhan, to spur rate reductions in line with MFI capacities.[14] Commercial banks can also play a greater role in this area by issuing and enforcing interest rate reduction targets to their MFI partners, thus challenging their clients to reduce rate charges over time.

[10] www.statebankofindia.com (August 12, 2006)

[11] Consultative Group to Assist the Poor (CGAP). *Guiding Principles on Regulation and Supervision of Microfinance*. pp. 13. (2003)

[12] The Economic Times-Hyderabad. Opinion Editorial. "Cap the Interest Rate on Microfinance?" (March 21, 2006)

[13] Y.S.P. Thorat. *Microfinance in India: Sectoral Issues and Challenges*. Theme Paper at the High Level Policy Conference for Microfinance in New Delhi, India. pp. 9. (2005)

[14] Sa-Dhan's Voluntary Code of Conduct dated March 21, 2006 made significant strides in this area, advising Sa-Dhan members not to charge above a 21-24% effective interest rate on a diminishing balance.

2.3.2 Increased monitoring of rate trends-a path towards rate reductions?

Though the level of micro credit interest rates should be left unregulated, the regulator need not stay out of rate regulation altogether. India's central and state governments can play a central role in reducing interest rates *without* introducing rate caps. One clear step forward would be to require all institutions engaged in micro credit, regardless of size, to register with some national or state-level authority. Each institution would then be required to provide this authority with quarterly disclosures of their effective interest rate offerings. This need not be an onerous registration process for smaller NGO-MFIs. It could just be a simple annual registration form and an equally simple quarterly rate disclosure form, coupled with periodic random audits to verify the disclosed information. This data could then feed into a straightforward, regionally or centrally maintained database. The authority could then monitor this database, identify the states and districts where interest rates are exceptionally high (or are failing to fall), and compare these trends with the relative level of competition in these regions. If the regulatory authority finds that lending rates are stagnating at unreasonably high levels despite competition, it may want to consider a policy intervention to increase its provision of lower, subsidized rates. However, if it appears that increased MFI competition in a given district is gradually driving down interest rates towards commercial banking levels, the authority may want to focus its energies on fostering greater MFI competition and increasing its support for other services for the poor like promoting more rural infrastructure projects or funding more vocational training programs.

It should be noted that a rate monitoring system can be created long before a fully-fledged credit bureau. It requires only a simple database. The stumbling block on rate reporting is not technology, but MFI transparency.

2.4 Micro credit interest rate controversies: A problem of MFI transparency

The controversies surrounding MFI interest rates stem largely from shortcomings in MFI transparency. While the Indian micro credit regulator needs to monitor the effects of MFI competition on interest rate levels, this cannot be done unless the monitor has access to verifiable and comparable interest rate data. At present, the sector has yet to agree upon a standardized methodology to dictate how MFIs should disclose effective interest rate charges including loan processing fees, bad debt provisions, and other ancillary charges. This makes it difficult to compare rate charges across MFIs and completely undermines the value of rate monitoring.

In addition, advocates for interest rate caps maintain that micro credit borrowers are often over-indebted. Therefore, they argue, interest rate caps are needed to ration the flow of credit to poor borrowers to avoid over-indebtedness. In response, MFIs try to refute this claim by pointing to low borrower default rates. However, because Indian MFI transparency norms are weak, these numbers cannot be trusted. Skeptics contend that most MFIs simply rollover their bad debts, thus concealing borrower defaults. While some MFIs certainly try to conceal borrower defaults, we cannot know the extent of this practice unless MFI treatment of non-performing loans is formally standardized and strictly enforced.

In sum, weak MFI transparency norms fuel misinformation in the sector. Because politicians and regulators have little verifiable data on which to base their decisions, these information gaps tend to exacerbate each regulatory issue facing the sector.

3 Encouraging accounting, disclosure, and behavior norms through regulation

CGAP's MFI Disclosure Guidelines[15] offer the best benchmark for judging institutional transparency. All Indian MFIs should work to comply with these guidelines. India's micro credit market can claim only one institution among the sixty-eight international MFIs who received CGAP's 2005 Financial Transparency Merit Award.[16]

Improvements in MFI financial transparency will serve three central benefits:

1. Enhancing service delivery.

[15]For more information on CGAP's MFI reporting standards, see *Microfinance consensus guidelines: Disclosure guidelines for financial reporting by microfinance institutions.* The Consultative Group to Assist the Poor. www.cgap.org. (July, 2003)

[16]SKS received the distinction in 2004 and 2005. It may be noted here that CGAP requires MFIs to submit an application to be considered for this award. For more information on the CGAP Financial Transparency Award, visit www.cgap.org.

2. Attracting greater commercial banking and private equity interest in the sector.

3. Improving the reputation of MFIs outside the sector.

Self-regulation and formal regulation are the two most commonly used tools for prodding an MFI sector towards universal adoption of rigorous transparency norms.

3.1 Achieving MFI transparency and behavior standards through self-regulation

The Reserve Bank of India is understandably hesitant to directly regulate the disclosure practices of all Indian MFIs; the RBI is already stretched thin supervising commercial banks, Urban Cooperative Banks, and the roughly 13,000 non-banking financial companies (NBFCs) in India. As such, the RBI has largely left MFI regulation to the MFIs themselves. Sa-Dhan's[17] Voluntary Code of Conduct (March 2006)[18] made major strides in filling this regulatory vacuum by providing member-MFIs with some general disclosure and behavior norms. Four especially salient guidelines in the document include the following:

1. MFIs will indicate interest rates, including loan processing and other charges, on an annual percentage rate basis (effective rate on a declining balance basis).

2. MFIs will adopt a high standard of corporate governance, with eminent independent board members and fully involving them in policy related decision.

3. MFIs will not take original land titles, house pattas, ration cards, etc. as collateral security for loans but can take copies of these for fulfilling "know your customer" norms of the RBI.

4. MFIs will strictly instruct staff members not to use abusive language or intimidation tactics while collecting repayment and will dismiss those staff members who do so.

While the Sa-Dhan code of conduct provides useful guiding principles to direct MFIs towards certain norms, it lacks the precision needed to spur true sector-wide standard-

[17]Sa-Dhan is a consortium of Indian microfinance organizations.

[18]*Voluntary mutual code of conduct for microfinance institutions.* Sa-Dhan (March 21, 2006). www.Sa-Dhan.org.

ization. To meet this demand, Sa-Dhan is collaborating with the Institute of Chartered Accountants to draft detailed accounting and disclosure guidelines for Indian MFIs. Ensuring sector-wide adoption of these norms, however, will be far trickier.

3.2 Self-regulatory organizations: Credible rule enforcers?

Does self-regulation offer sufficient rule enforcement capacity to spur improved MFI transparency norms? The real concern in Indian microfinance lies with the few MFIs who *are not* willing to voluntarily improve their transparency standards. Therefore, encouraging better MFI transparency requires both detailed guidelines *and* credible enforcement mechanisms. Does Sa-Dhan have the power to sanction rule breakers? At present, no. Its only means to punish deviant MFIs is to deny them future membership. Adding teeth to Sa-Dhan's rule enforcement capacity (like immediate membership suspension, or aggressive fines) will go a long way towards improving MFI transparency norms throughout the sector. However, international experience strongly suggests that self-regulatory organizations have serious limitations as credible rule enforcers.[19] Furthermore, even if Sa-Dhan had real enforcement capacities, its authority as a regulator would be limited to Sa-Dhan members only.

3.3 Policy Recommendations

Credible enforcement and the need for formal regulation

At present, the MFI sector is being judged by its worst rule-offenders. Until those MFIs face the real threat of clearly defined and formally enforced sanctions for their misbehavior, their incentive to invest in better governance and accounting practices will be insufficient to prod them towards reform. Thus, formal micro credit regulation should impose and adequately enforce the following MFI transparency norms:

1. Uniform financial statements and reporting guidelines for *all* institutions offering micro credit. This must include unambiguous norms dictating how MFIs must treat non-performing loans.

[19]For further discussion on the limitations to self-regulation of financial intermediaries, see CGAP's Guiding Principles on Regulation and Supervision of Microfinance. pp. 29-30. (2003)

2. Clear interest rate disclosure guidelines, including standards for disclosing loan processing fees, bad debt provisions, and all other ancillary and/or hidden charges.

3. Well-defined MFI staff behavior norms with clearly stipulated sanctions for rule-breaking institutions.

4. Requirements mandating that all MFIs above a certain portfolio threshold be audited on an annual basis by a chartered accountant trained in MFI auditing practices.

Absent these *formal* regulatory provisions, some MFIs will continue to engage in practices which threaten the reputation and viability of the entire sector. While the RBI may be unable to adequately regulate the space itself due to its existing supervisory responsibilities, it should, along with Sa-Dhan and NABARD, take the lead in creating a separate, micro credit-specific regulatory body to monitor and regulate the MFI transparency norms discussed above.

4 Encouraging MFI transparency through 3rd party ratings

Is there a need for regulatory intervention?

Mandated disclosure and behavior norms are not the only means to promote greater transparency in the sector. Encouraging independent 3rd party ratings of MFIs can be another important catalyst. Roughly 60 Indian MFI are rated annually, including nearly all of the 30 largest MFIs. Each year, SIDBI negotiates with M-CRIL and CRISIL on the bulk purchase of most of these ratings, making SIDBI the main driver behind India's MFI ratings market. Interestingly, neither MFIs nor commercial banks have shown much interest in formally purchasing these reports. In fact, according to SIDBI, fewer than 5% of all MFI rating reports in India are formally purchased by MFIs or commercial banks.

Citing the weak market demand for MFI ratings, many stakeholders suggest the need for formal regulation to require that all MFIs above a particular portfolio threshold be rated by an approved rating agency such as M-CRIL or CRISIL. It is argued that formally mandated discipline will lend greater credibility to the sector, encourage larger capital flows to MFIs, and improve MFI governance and transparency. However, before demanding regulatory intervention to promote MFI ratings, one should first assess why India's MFI ratings market is still not self-sustainable.

4.1 Bank loans to small MFIs

Screening via step-lending strategies rather than rating reports

When commercial banks make loans to small MFIs (< 3,000 borrowers), they tend to employ (to varying degrees) a "step-lending strategy" rather than a formal rating report. For example, a commercial bank's first loan to a startup MFI is often quite small, sometimes as low as Rs. 10-15 lakhs. If the MFI repays the loan on time, the bank extends a larger loan, and so on. This strategy significantly reduces the bank's due diligence costs for screening multiple small MFI clients. However, the step lending system has its obvious limitations, not least because it slows the flow of lending to even strong institutions within this market segment. This creates a space for state support of small MFI rating services.

4.1.1 NABARD rating support scheme

Promoting small MFI ratings through subsidies

NABARD launched an MFI rating subsidy scheme in June 2005, offering to reimburse 75% of the professional fees for the *first* CRISIL rating of MFI's, subject to a maximum of Rs.79,000.[20] Because most large-scale MFIs have already been rated multiple times, this proposal directly targeted small-scale MFIs.[21] As of March 31, 2006, only one MFI had been rated under the plan. This prompted NABARD to revise the proposal by increasing the reimbursement percentage to 80% and by adding M-CRIL, Planet Finance and other rating agencies to the list of institutions eligible under the plan.[22] However, the slow take up of NABARD's scheme begs the question: "Do commercial banks have use for rating reports for small scale MFIs?" The general consensus in the sector is no. As long as small-scale MFI repayment rates remain high, most commercial banks will continue to choose a simple step-lending strategy rather than first paying for the cost of a rating and

[20]NABARD Circular Number 79 dated May 11, 2005.
[21]Defined here as MFIs having between 1,000 and 5,000 clients.
[22]NABARD Circular Number 76 dated May 24, 2006.

then taking the time to file for a reimbursement from NABARD.

4.1.2 Ratings for small MFIs can have sectoral benefits

However, this is not to say that promoting ratings for small-scale MFIs would not have important benefits. Third party assessments can prod small MFIs to improve their governance and transparency systems, thus encouraging them to evolve into larger, more sophisticated and more secure MFIs. In addition, by subsidizing ratings for small MFIs in underserved states such as Bihar or Uttar Pradesh, NABARD can help attract commercial banking interest to these states. Despite these benefits, however, it is still unlikely that commercial banks will be willing to pay for even subsidized ratings of *small* MFIs.

4.2 Bank loans to large MFIs: An informal market for rating reports

Loans to large MFIs typically pose enough risk to a banking group's overall microfinance portfolio to make simple step lending strategies far less viable. Extensive due diligence and/or the use of a 3rd party rating report are more appropriate methodologies for screening loans of this size. However, very few parties have purchased ratings of even large-scale MFIs. This is mainly because SIDBI does not take a proprietary approach to the ratings it purchases, typically distributing the draft rating report to interested parties upon request (for example, commercial banks, equity investors, or donors), thus obviating the need for a formal purchase of an MFI rating.

4.2.1 Implications

One could argue that India's MFI ratings sector is functioning fairly well. Interested parties have access to formal ratings for the largest MFIs in the sector. Furthermore, SIDBI has signaled its intention to provide continued support for India's MFI rating sector for the foreseeable future. Nonetheless, this scenario prompts the following question: "Would India's ratings market take off with *multiple* buyers if the informal distribution channels for rating reports were curtailed?" This directly addresses the market value placed on formal rating services. If commercial banks, equity investors, donors, and MFIs perceive sufficient value in these ratings services, then would the MFI ratings market not function on its own?

4.3 Assessing the value of rating reports

Commercial banks argue that there is a disparity between the information supplied by MFI rating reports and the information banks actually use to screen potential MFI partners. For example, most banks say they base their lending decisions primarily on MFI transparency, governance, accounting practices, and control systems. In contrast, the banks argue, most rating reports focus a disproportionate amount of their analysis on MFI financials. As a result, some commercial banks suggested that they would continue to screen MFIs through their internal evaluation tools unless 3rd party MFI rating systems were modified to better address their actual screening requirements. However, a look at an M-CRIlL rating report reveals a heavy emphasis on transparency, governance, and information management systems. It is, therefore, unclear whether these complaints reflect genuine dissatisfaction with existing rating reports or a general comfort with the status quo wherein commercial banks have *free* access to available rating reports.

4.3.1 Implications

Whatever market value one attributes to MFI rating reports, there is clear scope to better tailor these reports to meet the lender's screening needs. This is an area where a third party such as NABARD can play a significant role, by sponsoring collaborative workshops among ratings agencies, MFIs, and commercial banks to periodically refine and customize ratings reports to meet the needs of all interested parties. Over time, this collaborative process will help the MFI rating market stand on its own without SIDBI support.

4.4 Policy Recommendations

India's micro credit sector is rapidly evolving. This suggests that it is quite prudent for the RBI or some other micro credit regulatory body to take a "wait and see" approach to some aspects of micro credit regulation. For example, if the partnership model becomes the primary channel for micro lending, the average MFI will become more a pass-through service company than a financial services provider. This would shift the rating requirement completely as banks would then screen MFIs based on their service capacities rather than their credit risk. As such, India's micro credit regulator should give the sector time to evolve before it considers any formal rating requirements, lest those requirements lose relevance in a rapidly changing sector.

With SIDBI support, India's MFI ratings market is functioning relatively well. Through its bulk purchase scheme, SIDBI is paying for the ratings at a reasonable cost. The information is then disseminated to interested parties. Most importantly, almost all the largest MFIs are rated on an annual basis, thus making formal rating requirements, at present, a redundant proposal.

In sum, SIDBI's continued support for the MFI ratings coupled with the fast evolving nature of the sector strongly suggests that it is unnecessary, at this time, to introduce formal regulation to mandate MFI ratings.

5 Domestic equity investment regulation

5.1 Venture Capital investment in NBFCs

The Securities and Exchange Board of India (SEBI) prohibits venture capital funds from investing in financial services companies.[23] As such, domestic MFI equity investors such as the Bellwether Microfinance Fund must register as NBFCs.[24] While it is unclear if liberalizing VC restrictions would spur significant investment in the sector, some domestic and foreign VC's have expressed interest in the space. As such, there could be real benefits to relaxing this constraint, not least because the micro credit sector is especially short on *domestic* capital sources at a time when India's venture capital industry is growing apace.[25] Allowing NBFC-MFIs to tap at least some of this growing capital pool could help fund much needed sector expansion into underserved areas.

[23]Securities and Exchange Board of India, Venture Capital Funds Regulations, 1996. Chapter 3, Section 12. *Restrictions on investment by a venture capital fund.* www.sebi.gov.in

[24]The main disadvantage here is that an NBFC equity fund can't benefit from the tax advantages afforded to VC funds.

[25]In FY2005, India received roughly $1.1 billion in venture capital investment, compared with $200 million in 2001. *Global Venture Capital Insights Report 2006.* Ernst & Young. www.ey.com. Estimate from TSJ Media.

5.2 NGO/Society investment in NBFCs

India's Income Tax Act of 1961 prohibits societies from investing in any non-charitable companies.[26] A Re.1 investment in a non-charitable organization exposes a society's *entire* business to income tax. By all accounts, this is the most significant curb on domestic equity investment in India's micro credit sector as it prevents many NGOs/societies from promoting NBFC-MFIs.

Some societies have circumvented this restriction by floating a Mutual Benefit Trust (MBT). Through this channel, the society can promote its MFI arm in two ways.

1. The society offers grant money to the MBT which then uses that money to invest in the NBFC.

2. The society's clients promote the MBT individually and the MBT then uses this client capital to invest in the NBFC.

While MBTs do not have the same tax-exempt status as societies, they do provide an indirect channel through which a society can promote an NBFC without exposing its entire business to income taxes.

NGO equity investment regulations are a tricky matter. If laws are too lax, for-profit businesses can use the loophole to shield their earnings from taxes. If laws are too stringent, NGOs are unable to promote their micro credit arms as NBFCs. What is clear is that many highly competent, socially-conscious NGOs cannot graduate their micro credit arms to NBFCs because of this restriction. As such, this topic deserves urgent attention from India's tax authorities. Serious collaboration between India's Income Tax Department and representatives from India's burgeoning NGO sector could yield a healthy compromise on this issue.[27]

5.3 NABARD's Micro Finance Development and Equity Fund (MFDEF)

There is some hope that NABARD's recently reconstituted Micro Finance Development and Equity Fund (MFDEF) will ease the domestic capital constraints faced by many Indian MFIs. Established in 2001, the fund is supported through contributions from NABARD

[26] Income Tax Act, 1961. (Section 11.1 and Section 11.5). www.taxmann.com.
[27] For more on RBI NBFC registration requirements, see Section 7.

(40%), RBI (40%), and eleven commercial banks (20%). The NABARD circular dated 5.24.06 announced that the fund has been increased to Rs. 200 crores and will provide debt, equity, and grant support to MFIs. NABARD has repeatedly suggested that it will invest primarily in those MFIs that have difficulty in accessing funds from other sources. Therefore, in its current form, the MFDEF will not be co-investing alongside Bellwether, Lok Capital, and other MFI equity funds.

To date, the fund has yet to make an equity investment in an MFI. To many in the sector, this reflects uncertainty about the MFDEF's investment strategy. Two key questions remain unanswered:

5.3.1 Does the MFDEF's equity investment arm have a return target?

The conventional equity investor serves as a market screening mechanism by rewarding only a sector's most promising institutions with capital investment. In a socially conscious venture, such as micro credit, the most promising institutions are those with the governance, transparency, and financial management expertise to offer the poor the highest quality services at the lowest possible cost. Socially conscious investors with rigorously applied screening requirements seek to reward precisely these MFIs. In contrast, the MFDEF seeks to target those MFIs which *cannot* receive their equity from other sources. This raises a serious question: If the fund lacks reasonable return targets (as is often the case in state run equity investment schemes), will it maintain a rigorous diligence process? If not, it runs the risk of undermining the typical market screening function played by conventional equity investors. This could facilitate the emergence of suboptimal players in the sector. However, with proper screening/return requirements, the MFDEF could serve as a major sector catalyst by funding the expansion of promising start-up MFIs.

One possible solution would be to separate the MFDEF's grant making and investment making arms into two separate entities. This would permit the fund's equity investment managers to adhere to strict return guidelines, thus prodding them to invest only in the strongest start-up MFIs in the sector. The grant making arm could then focus its efforts entirely on non-profit making ventures like offering grants for MFI capacity building or providing financial and technical support towards the establishment of a national credit bureau. However, the MFDEF's current structure risks confounding these different objectives.

5.3.2 Will the MFDEF distribute funds impartially?

Lastly, there is considerable hope that the creation of the MFDEF signals NABARD's intention to employ a more secular approach in supporting both SHG-bank linkage MFIs *and* Grameen-model MFIs. It can only benefit the sector to have the MFDEF distributing funds to the institutions with the strongest governance, monitoring systems, and service delivery. While NABARD's deep involvement in the SHG-bank linkage program may direct a significant portion of this money to supporting its own initiatives in the space, many stakeholders believe the creation of the MFDEF could augur a much more evenhanded approach in its support of the two models.

6 Foreign equity investment regulation

In practice, foreign direct investment (FDI) regulation applies only to NBFC-MFIs. Though Section 25 Companies are legally permitted to receive foreign equity investment, their not-for-profit status prevents them from extracting profits and paying dividends. These restrictions obviously limit their attractiveness as equity investments.

The RBI is particularly cautious in its approach to foreign ownership of NBFCs. The failure of multiple Indian NBFCs in the mid-1990's figures prominently in discussions about current NBFC-FDI restrictions. Regulators argue that local control over these bodies eases the RBI's monitoring requirements. Most importantly, minimum capital requirement serve as a screening device to ensure that only serious, committed foreign investors invest in NBFCs. Otherwise, it is argued, NBFCs will be overly exposed to capital flight from short-term investors. However, the RBI's desire for local ownership of NBFCs must be weighed against the *urgent* need to solicit foreign investment funds in supporting India's efforts to create a financially inclusive society. Both factors demand consideration, but the sector's current capital needs suggest that restrictions limiting FDI entry into NBFC-MFIs should be relaxed.

6.1 Existing Regulation

NBFCs can receive foreign equity investment subject to certain minimum capital requirements which are linked to the level of foreign ownership in the company. For equity stakes between 0-51%, the minimum capital requirement for *any* FDI is $500,000. This amount can include any number of foreign shareholders as long as the total up front foreign investment exceeds $500,000.[28] As shown in the table below, the capital requirements increase sharply as the foreign ownership stake increases beyond 51%

Minimum Capitalization requirements for foreign equity investment in NBFCs

Percent Ownership	Minimum Capital Requirement	Other Stipulations
0-51%	$500,000	Entire amount must be contributed up-front
51-75%	$5,000,000	Entire amount must be contributed up-front
76-100%	$50,000,000	$7.5 million must be contributed up-front. The balance must be provided within 24 months

Source: www.rbi.org in RBI Circular on Foreign Direct Investment (7/01/2006). Annex-2, Sector 2 (NBFCs)–Sector Cap on Investments by Persons Resident Outside India.

6.2 Modifying the 0-51% minimum capital requirement

There is considerable concern that existing FDI capital and ownership requirements pose serious obstacles to foreign equity interest in the sector. For example, before an NBFC can receive *any* FDI, it must first raise $500,000 in matching domestic equity to avoid eclipsing the 51% foreign ownership limitation. Otherwise, the foreign capital requirement would ratchet up to $5 million. However, as mentioned before, domestic equity in micro credit is in short supply. Therefore, restrictions on domestic equity investment in NBFC-MFIs curb both domestic *and* foreign sources of equity capital.

[28]For example, in November 2005, Vinod Khosla and Grameen Foundation-USA each invested $250,000 in Cashpor Financial and Technical Services. This coordinated investment combined to meet exactly the $500,000 minimum capital requirement for equity stakes between 0-51%.

It is also important to note that existing FDI regulations skew foreign equity funds away from start-up MFIs which lack the scale to attract individual equity investments of this size. While many foreign investors may be willing to make smaller investments in one or more well-run institutions, few are willing to invest $500,000 in a single NBFC-MFI.[29] Additionally, different MFIs require different amounts of capital. One MFI may require $250,000 in capital while another may require $700,000. Enforcing a $500,000 minimum prevents NBFCs from receiving optimum levels of foreign investment.

Due to these concerns, the most onerous NBFC-FDI restriction is clearly the $500,000 minimum capital requirement. We propose reducing this initial requirement to $100,000. This will still discourage non-serious investors from investing in the sector, but will create more breathing room, both to optimize the size of equity investment and to attract a greater pool of foreign investors.

6.3 Modifying the majority ownership requirement

Equity investors typically prefer having minority stakes in NBFCs. This leaves more space to craft high-powered equity-based incentive packages for local managers. The RBI also prefers local ownership of NBFCs because it eases its monitoring task. Thus, there is a case for having a substantial step-up in the FDI required to achieve a majority stake in an NBFC. However, there is also real concern that the 10x increase in capital requirements accompanying the jump from 50% to 51% ownership is too sharp. One alternative is a slightly more gradual FDI capital/ownership requirement scale rather than the three-tier structure outlined above. As a possible benchmark, the regulatory structure presented below represents a *micro credit-only* NBFC-FDI regulatory structure alternative that incorporates far lower capital/ownership hurdles and a slightly more gradual scale.

[29] With a proper screening system in place, NABARD's MFDEF could help fill this gap by making sound investments in start-up MFIs.

Proposed Alternative: Minimum Capitalization requirements for foreign equity investment in NBFC-MFIs

Percent Ownership	Minimum Capital Requirement	Other Stipulations
0-25%	$50,000	Entire amount must be contributed up-front
26-50%	$100,000	Entire amount must be contributed up-front
51-75%	$500,000	Entire amount must be contributed up-front
76-100%	$1,000,000	Entire amount must be contributed up-front

Most of India's poor still lack even basic financial services. If foreign investors want to help India alleviate this pressing problem, their investments should be welcomed, subject to minor controls. A structure of the kind presented above would open up the sector to many more potential foreign investors while still encouraging local NBFC-MFI ownership.

7 Minimum Capital Requirements for NBFC Registration

7.1 Existing Regulation

As mentioned before, the RBI is already over-extended in its supervisory requirements. Stretched thin by its supervision of commercial banks, Urban Cooperative Banks, and the roughly 13,000 NBFCs under its purview, the RBI is understandably keen to curb the flow of microfinance institutions registering as NBFCs.[30] The RBI rations this number by enforcing a minimum capital requirement for NBFC registration:

1. NBFCs commencing business before April 21, 1999 must have Rs. 25 lakh in net owned funds.

2. For NBFCs commencing business after April 21 1999, this requirement increases to Rs. 200 lakh.[31]

[30]At the end of June 2004, the RBI had received 38,050 applications from NBFCs for certificate of registration. Of these only 13,671 were approved, including 584 from companies authorized to receive public deposits. "The non-banking sector from a regulatory prism." The Hindu (December 20, 2004).

[31]RBI notification number DNBS 132 dated April 20, 1999. "Minimum Net Owned Fund (NOF) for commencement of business of a Non-Banking Financial Institution (NBFI)." Broadly defined, net owned funds includes shareholder capital and internally generated reserves.

Until very recently, Indian MFIs had little access to equity capital. As a result, most start-up MFIs had to meet this requirement with internally generated capital. This scenario made the Rs. 2 crores minimum capital requirement prohibitively high. However, two recent developments suggest that this requirement is no longer an extreme hindrance to NBFC registration:

7.2 Softening the minimum capital requirement

Increased access to equity capital

The entry of domestic microfinance equity investors such as SIDBI, NABARD's Micro Finance Development and Equity Fund (MFDEF), and Bellwether Microfinance Fund have eased the domestic equity constraint faced by Indian MFIs. Additionally, foreign equity investors such as Silicon Valley venture capitalist Vinod Khosla, The Unitus Equity Fund, and the Michael and Susan Dell Foundation have also invested in the space.[32] This is not to say that MFI capital needs have been fully met by these developments. As mentioned before, RBI and SEBI equity investment restrictions still prevent significant flows of capital from entering the sector. However, as more microfinance equity investors emerge, the Rs. 2 crores minimum capital requirement is quickly becoming a reasonable screening device.

7.3 Softening the minimum capital requirement

Investment in pre-April 1999 NBFCs

The steady increase in equity capital flows into India's micro credit sector isn't the only factor softening the effect of the Rs. 2 crores stipulation. Investors can purchase the assets of an NBFC registered before April 21, 1999. This enables a new MFI to register itself as a *pre*-1999 NBFC requiring only Rs. 25 lakh of equity capital. The RBI has taken a benign regulatory approach to this strategy as it (and the sector) stands to benefit in four key ways:

[32]In addition to these foreign equity providers, Lok Capital LLC is a $12 million, Mauritius-based fund targeting equity investments in Indian MFIs. As of August 2006, the fund had not yet made an investment in the sector.

1. It allows the RBI to clean up the non-operational institutions under its purview while transforming these entities into healthy financial institutions.

2. It allows MFIs to register as NBFCs without adding to the RBI's paperwork and filing costs. (the NBFC registration process has already taken place prior to April 1999)

3. It enables the RBI to screen in the NBFC applicants, not on capital accumulation alone, but on management expertise, track record, and overall business strategy.

4. If the RBI substantially lowered the minimum capital requirement for NBFC registration, it would surely face an increase in the number of NBFC applicants. This increased flow would swell even further if the RBI also relaxed MFI equity investment restrictions. By permitting NBFC asset purchases, the RBI maintains control over the NBFC registration process while leaving room for further equity investment liberalization down the road.

7.4 Policy Recommendations

The factors outlined above suggest that the Rs. 2 crores minimum capital requirement need not be reduced.

Assuming the RBI continues to relax MFI investment restrictions, equity capital should keep flowing into the sector. As such, India's best start-up MFIs will increasingly be able to attract the requisite capital to meet the Rs. 2 crores threshold. Also, by allowing only sophisticated MFI promoters to purchase non-operational pre-1999 NBFCs, the RBI can still ensure that only seasoned, committed professionals are at the helm of NBFC-MFIs. It is important to note that the RBI's current NBFC screening system moves India right in line with international guidelines on NBFC screening practices:

"Minimum capital needs to be set high enough so that the supervisory authority is not overwhelmed by more new institutions than it can supervise effectively....However, minimum capital is not necessarily the only tool available to limit new market entrants....licensing decisions can be based in part on qualitative institutional assessments." (CGAP 2003)[33]

[33]Consultative Group to Assist the Poor (CGAP). Guiding Principles on Regulation and Supervision of Microfinance. pp. 19, pp. 31. (2003).

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