

**Report
of the
Internal Group
to Examine Issues Relating to
Rural Credit and Microfinance**



Reserve Bank of India

July 2005

July 19, 2005

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Central Office
Mumbai

Dear Sir

**Final Report of the Internal Group to
Examine Issues Relating to Rural Credit and Micro finance**

Please refer to our letter CAB.No. 5156/01.29.01/2004-05 dated May 28, 2005 forwarding the draft report of the Internal Group to you. The draft report was placed on the Bank's website on June 1, 2005 for seeking comments/views from the public. The Group has considered the feedback/comments received on the draft report and accordingly certain modifications have been carried out.

2. We now submit herewith the final report of the Internal Group. We would like to take this opportunity to thank Shri V. Leeladhar, Deputy Governor and you for taking keen interest in the working of the Group.

Yours faithfully

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Chairman

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ACKNOWLEDGEMENTS

First and foremost, the Group is deeply indebted to Shri V. Leeladhar, Deputy Governor, RBI and Shri A.V. Sardesai, Executive Director, RBI for showing keen interest in the working of the Group and their insightful comments on the approach of the Group. The Group is also thankful to Shri C.S. Murthy, Chief General Manager-in-Charge, RPCD, RBI for offering his analytical perspectives on the subject.

The Group thankfully acknowledges the valuable inputs provided by a number of banks, NGOs/MFIs and their associations like Sa-Dhan. The Group would like to make special mention of the eminently useful presentations made by the executives of ABN Amro Bank, Dena Bank, HDFC Bank, ICICI Bank, SIDBI, State Bank of India and UTI Bank besides the Hindustan Lever Ltd. and ITC Ltd. The Group also acknowledges the very useful material received from Mr. Amaro Luiz de Oliveira Gomes, Managing Director, Banco Central do Brasil.

The Group also acknowledges the feedback from the Regional Offices of the Reserve Bank of India (RBI) that provided useful ground level inputs based on their interactions with local banks, NGOs and other experts. In particular, the Group would like to place on record its appreciation of Shri R. Gandhi, Regional Director, Dr. (Smt.) Deepali Pant Joshi, Chief General Manager and their colleagues of RBI, Hyderabad for their contributions and for organizing meetings with a number of NGOs/MFIs and banks in Hyderabad. The Group is obliged to Dr. A. Sahoo, Regional Director, Assam and North Eastern Region for his valuable feedback

The Group is highly indebted to Dr. Y.S.P. Thorat, Managing Director, National Bank for Agriculture and Rural Development (NABARD) and his colleagues at the Head Office and Shri N. Srinivasan, Chief General Manager, NABARD, Regional Office, Pune for enlarging the perspectives of the Group by their valuable comments and suggestions. . The Group would like to express its sincere thanks to all other individuals and institutions who have offered their suggestions and comments in preparation of the draft report and the feed-back on the draft report which was hosted on the Bank's website on June 1, 2005 for public comments.

The Group would like to place on record its genuine appreciation of the untiring efforts and invaluable contributions made by Shri C.P. Mohan, Deputy General Manager and Member of Faculty, College of Agricultural Banking (CAB) Pune in preparation of the report. The Group is thankful to Shri S. Thyagarajan, Assistant General Manager and Member of Faculty, CAB, Pune for painstaking efforts in organizing necessary logistic support for smooth conduct of the meetings of the Group and the preparation of the report. The Group also acknowledges with thanks the useful contributions made by S/Shri Manoj Sharma, E.V. Murray K.R.P. Rao, and R.N. Dash, Deputy General Managers/Members of Faculty and Shri Simanchal Sahu, Assistant General Manager, CAB, Pune. The Group would also like to thank S/Shri V.N. Dange, S.L. Manegaonkar, R.B. Dalal and Smt. S.S. Gole for providing excellent secretarial support to the Group.

INTERNAL GROUP TO EXAMINE ISSUES RELATING TO RURAL CREDIT AND MICROFINANCE

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Chapter 1

Introduction

Background

1.1 The nation has been experimenting with various alternatives to reach the banking services, primarily credit, in rural areas through several initiatives. Early initiatives in this regard were taken by building an institutional framework beginning with the focus on the cooperative credit institutions followed by the nationalisation of major domestic banks and later the creation of the Regional Rural Banks (RRBs). Simultaneously, several measures including establishment of the Lead Bank Scheme, directed lending for the Priority Sectors, banking sector's linkage with the Government sponsored programmes targeted at the poor, Differential Rate of Interest Scheme, the Service Area Approach, the SHG-Bank linkage programme and introduction of the Kisan Credit Card were taken. Given the social responsibility to reach the rural areas and the poor, the banks and co-operative institutions with guidance from the Reserve Bank of India (RBI), the National Bank for Agriculture and Rural Development (NABARD) and other apex level institutions made serious efforts in meeting the needs and demands of the rural sector. As a result, the outreach of Indian banking system has seen rapid growth in rural areas. In so far as all the Scheduled Commercial banks (SCBs) including RRBs are concerned, 48 percent of their total branches (32,303¹ branches which translates to a population of about 23,000 per branch), 31 percent (13.67 crore) of their deposit accounts and 43 percent (2.55 crore) of their borrowal accounts are in the rural areas. Such an unprecedented expansion of the formal financial infrastructure has reduced the dependence of the rural populace on the informal money lending sector from 68.3 percent in 1971 to 36 percent in 1991. (All India Debt and Investment Survey, 1991).

1.2 However, there continues to be wide gaps in the availability of banking services in the rural areas as the SCBs have covered only 18.4 percent of the rural population² through savings/deposit accounts and even a lower percentage of 17.2

¹ Banking Statistics, RBI, 2003

² Rural population : India : 74,16,60,293 (2001 Census)

percent of the rural households³ by way of loan accounts. Though the Primary Agriculture Credit Societies (PACS) with about one lakh outlets⁴ have a deep and wide presence in rural India their impact in terms of extension of deposit and credit products has not only been minimal but concentrated in a few states only. The decline in productivity of the rural branches of the commercial banks, fragility of the co-operative credit structure and weakness of RRBs witnessed since early the 90s, have further accentuated the problem of inaccessibility of banking services for a large part of the rural population. Furthermore, as the banking sector has shown propensity towards the larger size accounts, the number of loan accounts of small borrowers with credit limit range of less than Rs.25,000/- has decreased from 5.88 crore in 1991 to 3.69 crore in 2003.

1.3 It is important to understand both the supply and the demand side perspectives that lead to such a wide gap in availability of financial services. The exclusion of large numbers of the rural population from the formal banking sector may be for several reasons from the supply side, such as: (a) persons are unbankable in the evaluation/perception of bankers, (b) the loan amount is too small to invite attention of the bankers, (c) the person is bankable on a credit appraisal approach but distances are too long for servicing and supporting the accounts and expanding branch network is not feasible and viable, (d) high transaction costs particularly in dealing with a large number of small accounts, (e) lack of collateral security, (f) inability to evaluate and monitor cash flow cycles and repayment capacities due to information asymmetry, lack of data base and absence of credit history of people with small means, (g) human resources related constraints both in terms of inadequacy of manpower and lack of proper orientation/expertise, (h) adverse security situation prevailing in some parts of rural India, (i) lack of banking habits and credit culture, (j) information-shadow geographical areas, and (k) inadequacy of extension services which is crucial to improve the production efficiency of the farmers leading to better loan repayments.

1.4 From the demand side, there are several reasons for the rural poor remaining excluded from the formal banking sector, such as : (a) high transaction costs at the

³ Estimated number of rural households : 147.90 Million (NSSO – 2003)

⁴ Source : National Federation of State Cooperative Banks.

client level due to expenses such as travel costs, wage losses, incidental expenses, (b) documentation, (c) lack of awareness, (d) lack of social capital, (e) non-availability of ideal products, (f) very small volumes / size of transactions which are not encouraged by formal banking institutions, (g) hassles related to documentation and procedures in the formal system, (h) easy availability of timely and doorstep services from money lenders/informal sources and (i) prior experience of rejection by/indifference of the formal banking system.

1.5 It needs to be noted that the initiatives that may be taken further to expand the banking outreach have to necessarily provide solutions for the comprehensive financial services to the rural sector. Thus, for example, the inability to save or withdraw savings from the formal sector may revert even those who are brought into the banking mainstream to the informal sector as it responds well to emergency needs. In this context, it needs to be noted that with good credit take off, the incremental Credit Deposit Ratio of banks are climbing to over 100 percent in recent times. Thus, the need to increase resources of the banks has become imperative. The potential to tap the rural areas for raising low cost deposits is high. It is now being widely accepted that by extending their reach to the vast numbers of untapped small and marginal clients in the rural areas at the bottom of the pyramid, banks can increase their business, enhance their profit and spread the risk. It is also increasingly recognised that the rural credit market offers good opportunity for profitable retail loan business. There is considerable upward mobility in terms income and savings potential among large sections of rural population, which the banks are unable to effectively reach due to the supply and demand side reasons mentioned earlier. Similarly, lack of remittance facilities may drive the people to continue to depend on informal sector and at the same time deprive the banking system the benefit of other income.

1.6 The situation described above has been responded to in some ways by banks with the involvement of Non-Government Organisations (NGOs) and other Civil Society Organisations (CSOs)/voluntary agencies in facilitating the flow of financial services to the poor. The most significant in this context is the SHG-Bank linkage programme. Another attempt in this approach is the delivery of credit through Joint Liability Groups. Further, in the recent times, several new generation banks who

came into existence with a heavy reliance on technology but with a very limited branch network, have taken innovative steps, such as, bulk lending to microfinance institutions (MFIs), using them as "pass through" agencies, to tap the rural credit market.

Budget Announcements of the Finance Minister

1.7 The Hon'ble Finance Minister has taken cognizance of the need to further accelerate the availability of banking services in rural areas, and leverage the existing socially active organisations in the process. In response, the two significant statements contained in paragraphs 48 and 53 were included in the Union Budget 2005-06. They were as follows :

Paragraph 48

Government intends to continue with its effort to turn the focus of commercial banks, regional rural banks (RRBs) and cooperative banks towards providing credit, especially production credit, to rural households and farm households. Particularly in agricultural credit, innovations are possible. I propose to request the Reserve Bank of India (RBI) to examine the issue of allowing banks to adopt the "agency model", by using the infrastructure of civil society organisations, rural kiosks and village knowledge centers, to provide credit support to rural and farm sectors.

Paragraph 53

At present, micro finance institutions (MFIs) obtain finance from banks according to guidelines issued by RBI. MFIs seek to provide small scale credit and other financial services to low income households and small informal businesses. Government intends to promote MFIs in a big way. The way forward, I believe, is to identify MFIs, classify and rate such institutions, and empower them to intermediate between the lending banks and the beneficiaries. Commercial banks may appoint MFIs as "banking correspondents" to provide transaction services on their behalf. Since MFIs require infusion of new capital, I propose to re-designate the existing Rs.100 crore Micro Finance Development Fund as the "Micro Finance Development and Equity Fund", and increase the corpus to Rs.200 crore. The fund will be managed by a Board consisting of representatives of NABARD, commercial banks and professionals with domain knowledge. The Board will be asked to suggest suitable legislation, and I expect to introduce a draft Bill in the next fiscal year.

Constitution of the Group

1.8 Following the above announcements, the RBI constituted an Internal Group with Shri H. R. Khan, Chief General Manager and Principal, College of Agricultural Banking (CAB), RBI, Pune as the Chairman and Shri K.D.Zacharias, Legal Advisor, Shri G. Srinivasan, Chief General Manager (CGM), Rural Planning and Credit Department (RPCD), Shri Lalit Srivastava, General Manager (GM), Department of Banking Operations and Development (DBOD), Smt. Asha P. Kannan, Director, Department of Economic Analysis and Policy (DEAP) and Shri P. Ahuja, Deputy General Manager (DGM), Department of Non-Banking Supervision (DNBS), all from the Central Office of RBI, as members. The terms of reference (ToR) of the Group were as follows:

- a. examine the issue of allowing banks to adopt the agency model, by using the infrastructure of civil society organisations, rural kiosks and village knowledge centres to provide credit support to rural and farm sectors and to suggest operating guidelines therefor;
- b. examine the feasibility and modalities for appointment of "banking correspondents" to function as intermediaries between lending banks and beneficiaries;
- c. identify steps to be taken to promote micro finance institution (MFIs) and propose a system for their classification and rating; and
- d. examine the extent of regulation, if need be, of MFIs.

A team in CAB comprising S/Shri Manoj Sharma, GM, E.V. Murray, DGM, K.R.P. Rao, DGM, S. Thyagarajan and Simanchal Sahu, Assistant General Managers (AGMs) with Shri C.P. Mohan, DGM as the key resource person supported the work of the Group with research inputs.

Approach of the Group

1.9 The Group held its four meetings on March 31, April 12, April 21, and May 11-12, 2005. The Group appreciated the various aspects of the issues involved and decided to hold consultations with various stake holders engaged in the process of extending the outreach of financial services. Within the constraints of time, the Group also had interactions with several NGOs, MFIs and their associations, banks,

corporate entities like ITC and Hindustan Lever Ltd. (HLL), NABARD and the Regional Offices of RBI through meetings and correspondence. The Group drew extensively from the experiences of microfinance practitioners in India, literature on cross country experiences and various responses received. The list of persons/organisations consulted by the Group and those who have given a written response to the Group is given in **Annex 1.1**. Special attention was paid to the reports of the Task Force on Supportive Policy and Regulatory Framework on Micro Finance set up by NABARD (1999), Sub-Group Reports of the Empowered Committee on Financial Flows to the Unorganised Sector established by the Prime Minister's Office (2002), the reports of the four Informal Groups set up by RBI on "Funding", "Capacity Building" "Structure and Sustainability" & "Regulatory" issues (2003) and the Report of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from Banking System set up by RBI (Vyas Committee, 2004). The Group also took keen interest in the important developments in the Information and Communications Technology (ICT) sector which can leap frog the banking sector in the delivery of quality and timely financial services to the remotest areas with significant efficiencies.

1.10 The Group drew strength from the following announcement by the Governor Dr. Y.V.Reddy in the recent Annual Policy Statement for 2005-06 wherein he has expressed deep concern on the exclusion of vast sections of the population from the formal financial system.

- “RBI will implement policies to encourage banks which provide extensive services while disincentivising those which are not responsive to the banking needs of the community, including the underprivileged.
- The nature, scope and cost of services will be monitored to assess whether there is any denial, implicit or explicit, of basic banking services to the common person.
- Banks are urged to review their existing practices to align them with the objective of financial inclusion”.

Structure of the Report

1.11 The report contains seven Chapters, including this introductory chapter that provides the background of the report, and eight Annexes. **Chapter 2** deals with the recent innovations and experiments in bridging the gaps in the banking outreach to

the rural poor. **Chapter 3**, which addresses parts "a" and "b" of the ToR, deals with policy options and strategies for deepening and widening of financial services. The prospects and possibilities of allowing CSOs / MFIs / other entities to function as business facilitators and agents/correspondents for expanding the reach of the banking facilities to the under serviced rural areas and the guidelines/benchmarks to be followed by the banks for the purpose have been described in this Chapter. **Chapter 4** dwells on promotion, development and rating of MFIs/other outreach entities and relates to part "c" of the ToR. **Chapter 5** deals with the question of regulation of MFIs, with particular reference to the need for a new and exclusive regulatory framework for the sector. Broad conclusions derived from the study of the Group have been highlighted in **Chapter 6**. The summary of the major recommendations is given in **Chapter 7** along with two **Appendices** showing a schematic diagrams of the proposed Models and the risk mitigation strategies therefor. **Annex 1.1** contains the list of persons and organisations consulted / from whom written responses were received. The broad features of the partnership model between MFIs and the banks are given in **Annex 2.1**. While the description of parameters used by rating agencies for rating MFIs have been presented in **Annex 3.1**, the indicative parameters for due diligence of different categories of micro finance providers have been highlighted in **Annex 3.2**. An account of ICT solutions for extension of the outreach of the banking channels alongwith flow charts on possible uses of technology under the Banking Correspondent Model is furnished in **Annex 4.1**. **Annex 4.2** diagrammatically represents the possible uses of corporate-bank linkage. A comparative statement on rating models used internationally and nationally is given in **Annex 4.3**. The gist of recommendations made by previous groups/committees on the regulatory aspects of the micro finance sector has been presented in **Annex 5.1**.

Chapter 2

Innovations and Experiments in Bridging the Gap

2.1 In evolving a comprehensive strategy for deepening and widening financial services in the rural areas and expanding the outreach of the formal financial system to the rural poor, the Group made a quick review of innovations and experiments being attempted in many countries as also in India in this regard. Many of these initiatives have, in recent times, drawn the attention of bankers, researchers, academics and policy makers. This chapter briefly captures such experiences and initiatives to provide cross country learnings and lessons for the way forward.

2.2. The Bangladesh Grameen Bank model and the micro finance programmes of BRAC and ASA in Bangladesh have by now been widely studied. Similarly, the experience of BRI Unit of Indonesia and micro finance experience of Philippines are by now quite well known. Although each of these were path breaking efforts and innovations in their time, they are not dealt here in more detail as these experiences have already been used in one form or other in designing the micro finance programme in India. The subsequent coverage has been limited to some recent cross country initiatives aimed at bridging the gap between the demand and supply for banking facilities by the hitherto underserved population, particularly the innovations in extension of micro finance services. The Indian adaptations and experiments in this regard have also been briefly covered.

Banking Correspondents in Brazil

2.3 The most talked about experience these days in microfinance circles is the Brazilian experience. Brazil shares several similarities with India, the main being the huge geographical area. However, unlike India, Brazil does not have a significant rural branch banking network. Even six years ago, 1700 out of 5500 municipalities in Brazil did not have a single branch of any bank. A large number of people were cut off from banking services as they were too poor or had no time away from work or too timid to even set foot in a bank. They had nowhere to deposit their money, no access to credit, except from family, friends or "loan sharks", and no chance of

building a credit history needed to apply for a loan. In 1997, banks and regulators responded to this situation by creating a network of "correspondents bancarios" or "banking correspondents", small outlets with extended working hours that offered basic banking services. At that time, 40 out of the 68 million economically active Brazilians had no access to formal financial services. Today, an additional 4 million have begun using banks for the first time through 27,000 banking correspondents. Under this arrangement, banks are permitted to appoint a wide variety of institutions/entities as correspondents/agents, which are easily accessible to people, e.g., drug stores, petrol pumps, super markets, small stores in neighbourhood, post offices and even lottery shops. The Brazilian model is largely technology driven and uses kiosks or automated teller machines by such agents to accept payment, open accounts, without a cheque book facility, take small deposits, provide micro credits, sell savings bonds and insurance.

2.4 Another initiative in Brazil has been the use of the Post offices network and Post Office staff to deliver banking services through Banco Postal. It may also be noted that in 2003, the Brazilian central bank extended the micro finance programme by allowing banks to draw on 2% of the reserves deposited with them and lend it to individuals and small businesses at concessional interest rates.

ACCION's Service Company Model of Latin America

2.5 ACCION International, a microfinance resource institution based in the USA and working in the American continents, has promoted the "Service Company Model" to expand micro finance operations. The model has been successfully replicated by SOGE BANK/ SOGESOL in Haiti and Banco del Pichincha/ CREDIFE in Ecuador. The Micro-finance Service Company is a non-financial company that provides loan origination and credit administration services to a bank by way of sponsoring, evaluating, approving, tracking and collecting loans, for a fee. The loans themselves are on the books of the bank. The Service Company can be a wholly owned subsidiary of the bank or may involve additional investors.

Teba Bank of South Africa

2.6 In South Africa, Teba Bank which was providing financial services to the mining industry since 1975, started targeting low income households in small towns and rural areas having limited banking facilities since 2000, after it was granted the licence to operate as a micro finance bank. The bank engages agents who are given hand-held mobile Point of Sale (PoS) devices. This wireless device has a built-in GSM modem, card reader and micro printer. The customer can use their debit card at the terminal to deposit and withdraw cash, make balance enquiry and transfer funds. Under this arrangement, physical cash can be deposited with /disbursed by agents. Typical agents in this model are the neighbourhood grocery stores and their accounts at the bank are instantaneously debited or credited.

Product Innovations for Micro Savings

2.7 Recent international experience indicates that micro savings are as important as micro credit. The following are some recent micro savings product introduced in different countries.

Contractual Savings Agreement by BURO Tangail, Bangladesh

2.8 BURO Tangail, an MFI operating in Tangail district of Bangladesh undertaking micro credit since 1989, has introduced unique savings product called "Contractual Saving Agreement". Under this, clients open deposit accounts and are required to make weekly deposits for an agreed tenure. The effective rate of interest on this deposit is higher than the usual saving deposit products. Failure to regularly deposit instalments attracts stiff penalty and failure to pay three deposits during the tenure of the scheme results in transfer of the deposit to a general savings account earning less interest. Almost 50% of the saving portfolio of the BURO Tangail today is under the Contractual Saving Agreement. The clients using this product are reported to be saving up in order to buy small parcels of land or to add/renovate housing.

Jijenge Savings Account in Kenya

2.9 Equity Building Society in Kenya has developed the Jijenge Savings Account, a contractual savings product with an emergency loan facility. The client defines the length of the contract and the periodicity of the deposits, which could be weekly or monthly. A premium interest rate is offered to those who take out longer term contracts and there are significant penalties for premature withdrawals. All Jijenge savings account holders have guaranteed, immediate access to an emergency loan of 90 percent of the amount in their Jijenge savings account. As well as providing a disciplined way to save, this product allows clients to meet their "illiquidity" preference and protects their savings against the demands of petty spending or "marauding relatives". The account is already proving extremely popular with existing and new clients.

Micro payments using text messaging

2.10 In Kenya, Commercial Bank of Africa in conjunction with local mobile operator *Safaricom* is enabling mobile subscribers to make micro payments from mobile phones. The majority of the people in Kenya do not hold bank accounts but purchase prepaid mobile refill cards. The technology allows settlement of bills by building up credit balance on the mobile phone and sending text message to make payments.

The Indian Experience

Pigmy Deposit Schemes

2.11 The pigmy deposit scheme, which involved daily/weekly collection of tiny deposits at the depositors' doorstep by engaging local people as agents, was operated in the past by a few banks. The experience of banks most of the time has been adverse, with cash leakage, frauds and accounting and reconciliation problems. Most banks have now closed such schemes after booking losses. There is need to learn from this experience and devise adequate checks and balances and utilize IT tools to make any future initiatives less risky for banks.

Mobile Banking

2.12 Banks have experimented with mobile banking in rural areas by several modes, including the use of mobile cash counters. The location and time of operation are usually synchronized with market days so that larger numbers of people could transact business. However, due to manpower constraints and inadequate volumes to cover costs, banks have not seen these operations as scalable models for wider replication.

Regional Rural Banks

2.13 RRBs in their original form were designed to be Micro Finance Institutions to bridge the gap between those served by Cooperatives and Commercial Banks and the large unserved population in the rural areas. In spite of being formed with a clear mandate and a defined objective, the RRBs moved away from their original mandate and became miniature versions of commercial banks. Over time, with ageing staff, branch rationalization (including shifting to more convenient locations) and focus on profitability and strong balance sheet, these banks have digressed from their social mandate. However, even today, as experience would show, in comparison to commercial and co-operative banks, RRBs offer the best fit for undertaking micro finance operations on a much larger scale considering their close understanding of the local people and geography. Today 196 RRBs together cover 516 districts and serve a client base of close to 6.27 crore.

Local Area Banks

2.14 Local Area Banks (LABs) were another initiative that was attempted to mobilize rural savings by local institutions and make them available for investment locally. The LABs set up in the private sector and regulated by the RBI were expected to bridge the gap in credit availability and strengthen the institutional framework in the rural and semi urban areas to provide efficient and competitive financial intermediation in their area of operation. As on date, only four LABs are functioning in the country. The LABs have, however, not made an impact on the local communities in which they function in terms of any significant indicators, such as, deposit mobilisation, the number of depositors, borrowal accounts, rural branches and poor people helped on account of fundamental weaknesses inherent in their business model. One serious handicap identified with the business model is

the absence of a refinancing facility which hinders both in managing maturity mismatches and their ability to lend at finer rates. Krishna Bhima Samruddhi, a Local Area Bank promoted by Basix in Andhra Pradesh, is the only LAB which is into the business of micro-finance on a large scale and has achieved operational efficiency in terms of profits and a high credit deposit ratio. The experiment of LAB needs to be revisited particularly from the point of view of providing another institutional framework for reaching the rural areas.

SHG-Bank Linkage

2.15 The SHG-Bank Linkage model is the indigenous model of micro credit evolved in India and has been widely acclaimed as a successful model with a present coverage of over 1.4 million groups involving a cumulative credit flow of Rs. 6300 crore as at the end of March 2005 from the banking system. Being a savings-first model, where credit discipline is inculcated in the group with their own funds, banks have found comfort in lending to such groups as they build up an adequate corpus of their own funds before they approach the bank for credit. In view of availability of social collateral and joint liability, banks have found the repayment experience encouraging enough to actually take charge of this programme. The significant learnings from the SHG oriented micro finance movement in India have been to (i) discover innovative methods of reducing the costs of intermediation, (ii) leverage peer pressure to mitigate default risks, (iii) use CSOs / informal groups, etc. for need and capability assessment, (iv) incentivise lending and thrift by forming a pool in which the scales are favourable for internal lending which in turn keeps the poor away from money lenders, (v) involve and facilitate NGOs/ CSOs to help banks to build up quality portfolios, (vi) ensure proper utilisation of funds available to groups which tend to function as self monitoring units, (vii) graduate from thrift to internal lending to consumption credit to micro enterprises by using the group approach, (viii) empower through collective decision making, conflict resolution, and other social activities, (ix) help the poor and asset-less to receive financial services through collateral substitutes, and (x) identify risks that can be managed by involving peer groups, NGOs/CSOs. Today, most banks have a corporate policy to expand their micro credit operations under the SHG-Bank Linkage mode.

2.16 However, one of the major roadblocks to accelerating the pace of this programme has been that SHG formation and pre-linkage operations are process intensive and involve upfront investments in manpower, time and cost. This requires the presence of NGOs of good standing and values to be able to collaborate with banks. The absence of NGOs in some parts of the country has been a stumbling block to the expansion of the programme in states, such as, Bihar, Uttar Pradesh and the North-East Region where in fact the poor are largely concentrated. However, as the banks are now strong votaries for popularizing and spreading this model the programme may soon assume the character of a large movement in these deficient areas.

OBC Grameen Project

2.17 Oriental Bank of Commerce (OBC) was one of the first Commercial Banks to pioneer micro finance under their "OB Grameen Project" in Uttaranchal and Rajasthan. A unique feature of this initiative was that unlike the SHG-Bank Linkage model where the SHG or its representatives come to the bank branch to transact, in the OBC model the bank officials go to the groups on pre-determined dates. This by itself was a revolutionary step. The experiment needs to be assessed further and lessons drawn from it.

The NGO/MFI Bulk Lending Model

2.18 An alternative delivery model for microfinance is the bulk lending model, where funds are placed at the disposal of NGOs or MFI for on-lending. SIDBI, Friends of Women's World Banking (FWWB) and the Rashtriya Mahila Kosh (RMK) have followed this route, along with some private and public sector commercial banks. The on-lending could be to SHGs or groups in Grameen Bank mode or even to individuals.

2.19 This model has faced problems of upscaling because it was found that many NGOs being "not for profit" entities were unable to undertake financial intermediation. Further, by their very constitution NGOs have low levels of capitalization. The ability to leverage borrowings to undertake financial intermediation on a large scale using their own capital and reserves, thus, had serious limitations. Another issue that the

private banks encountered was that on-lending involved two sets of exposures for them, once at the NGO/MFI level and again at the ultimate borrowers' level.

The Partnership Model

2.20 Out of these structural and operational constraints has evolved the "Partnership Model" which has been popularized by the new generation of private sector banks. In this model, the unique innovation is that the MFI evaluates, recommends, originates the loans, helps in disbursement and subsequently tracks and collects the loans. However, the loans sit on the books of the bank and not of the MFI. This model has overcome the constraints of capitalization of the MFI and the double exposure that the banks are exposed to. For the services that the MFIs provide a service charge is collected from the borrowers by the MFI. It also provides First Loan Default Guarantee (FLDG) to the bank to a certain extent (8 - 15%) of the limit sanctioned in the form of a security deposit with the bank so as to maintain its stake in the loan portfolio. Since MFIs find this deposit amount too large to mobilize, further innovation by providing the FLDG amount as an overdraft limit to the MFI has also been tried out. Broad features of the model are given in **Annex 2.1**.

Kisan Credit Card

2.21 The Kisan Credit Card, now popular all across the country, is a financial product innovation of far reaching significance. The card enables the farmer to get loans over a three to five year time frame as a revolving credit entitlement. These features give a farmer unlimited flexibility to manage his cash flows, reduces the documentation costs to a third or fifth of what was incurred in the past and also obviates the need for frequent branch visits, thereby keeping his travel costs to the minimum. A farmer's consumption requirements are also built into the credit limit, recognizing thereby that a banker's attempts at bifurcating productive and non-productive components of a loan does not match with a farmer's view in which caring for himself and his family is as important as crop husbandry. The reduction of work load for the rural bank staff due to simplification of documentation, a minimum of paper work and a reduction in transaction cost has resulted in better banker - client relationships. Many banks have innovated on the base KCC product and developed variants by integrating Term Loans and Crop Loans and providing other features akin to a 'General Purpose Credit Card' besides personal insurance linkage.

2.22 The national impact assessment survey conducted by the National Council for Applied Economic Research (NCAER), while bringing out several benefits of the KCC Scheme, has identified certain areas where further improvements are required, viz. restrictions imposed by banks on issuance of KCC due to security considerations, use of KCC only at the card issuing branches and lower credit limits. The Indian Banks' Association (IBA) is currently looking into these aspects.

2.23 While this product addresses the needs of the farmers and cultivators, there are a large number of artisans, agricultural labour, and household entrepreneurs who also need a product with the features and flexibility that the KCC offers. Further, a potential innovation that has yet to be experimented upon on a large scale but which could have far reaching implications for the future could be for a KCC with smart-card features which would facilitate POS transactions linked to the farmer's bank account.

Chapter 3

Deepening and Widening Financial Services: Policy Options and Strategies

3.1 Given the wide gap as it exists now, the focus has to be on further acceleration of efficient and effective delivery of credit to the rural farm and non farm sectors. As described earlier, the SHG model in India as well as several other micro finance initiatives across the world show that creation of awareness of banking products, competency for capacity building, handholding, nurturing and empowering individuals and groups from among those with small means essentially lie with the Civil Society Organisations (CSOs) outside the ambit of the formal banking system. Such organisations could well be organized NGOs / Voluntary Agencies, Co-operative Societies or loosely organized groups such as Farmers Clubs, SHGs, their federations, etc. Further, there could be corporates who are engaged in poverty alleviation and capacity building in rural areas in fulfillment of their objectives for Corporate Social Responsibility (CSR) or for strategic business reasons. These organisations have the expertise, attitude and interest to provide various support services which the poor may need even before they avail of credit for various purposes. It is also now widely recognized that with increase in awareness and build-up of equity in the form of savings and credit history, the poor would need credit in an increasing quantum depending on their stages of development. Keeping in view the necessity of secured savings for future use, need for reasonable return, as a source of long-term security of the households and means for inclusion in the mainstream of the financial sector, easier and wider availability of savings products has become imperative. With increasing rural-urban migration within and outside India, the need for remittance service to and from remote rural villages is also felt acutely. Protection against vulnerabilities of rural poor to disease, death, old age, disasters and natural calamities through micro insurance and pension schemes is also considered essential as social security measure. Thus, there is need for comprehensive financial services encompassing savings, credit, remittance, insurance and pension products which the formal financial system has not been able to provide effectively in the rural areas.

3.2 In this context, the innovations and initiatives described in **Chapter 2** hold out the promise of bringing in more and more unbanked population under the purview of the formal financial service providers like banks. The intervention of CSOs/ other external entities is expected to result in accelerating the process of linking the large numbers of hitherto unbanked persons with the banking network. Hence, leveraging appropriate external organisations /entities for the purpose is considered a viable policy option.

Extending Outreach – New Models & Arrangements

3.3 The Group explored various options and innovative approaches of linking the CSOs / other entities with banks to expand the latter's outreach. It felt that the linkages can be established under two broad models, one wherein the banks may use a wide array of CSOs and others for supporting them by undertaking non-financial services and the other under which institutional agents / other entities support the banks for extending financial services. The first may be called the "**Business Facilitator Model**" and the second, the "**Business Correspondent Model**". These two models are briefly described below:

Model A : Business Facilitator Model for Non-Financial Support Services

Scope of Activities

3.4 Viewed from the supply side, the banks may need several functions to be outsourced so that the transaction efficiency increases. These functions are in the nature of facilitation support services and may include (i) identification of borrowers and fitment of activities; (ii) collection of applications and verification of primary information/data; (iii) preliminary appraisal of credit based on standard norms set by banks and using local data/information (a simple credit scoring model may be employed); (iv) marketing of the financial products including savings / providing product information; (v) processing and submission of applications to banks; (vi) promotion and nurturing SHGs/JLGs; (vii) post-sanction monitoring; (viii) monitoring and handholding of SHGs/ JLGs/ Credit Groups/ others; and (ix) follow-up for recovery.

Types of Facilitators

3.5 It is envisaged that a large number of institutions/ persons, who currently interface between the rural poor and banks, can be leveraged to provide such support services under well defined terms and conditions by way of contractual arrangements. These agencies may be NGOs, Farmers Clubs, Functional Cooperatives, IT enabled rural outlets of corporate entities, Postal agents, insurance agents, well functioning Panchayats, etc. The banks may also leverage a large number of Rural Multipurpose Kiosks, and Village Knowledge Centres set up under private or Government initiatives under this Model. Over time, the facilitators may be encouraged to increasingly use available technological solutions and connectivity for disseminating latest product information, processing, filing of loan applications, viewing account details, etc. In addition to the above, depending on the comfort level that the banks may have, Agri Clinics/Agri Business Centers financed by banks, Krishi Vigyan Kendras, KVIC/ KVIB units, etc. can also be utilized for this purpose. The banks may also consider to engage ,on contract basis, properly identified and trained youth/ individuals including retired bank employees having familiarity with the local culture and language to work as facilitators. Based on experience and review, such persons may also be allowed to handle cash at a later date under the Business Correspondent Model described below. Such persons working under the contractual agreements can expand the reach of the banks at a very low cost and bring in a system of performance linked incentives often not found feasible in the prevailing organisational structure. NABARD's scheme of promoting Individual Rural Volunteers for promotion of SHGs is an example of using individuals for expanding the outreach. Banks may also consider engaging such farmer-volunteers for expanding their rural reach. A number of banks have set up/are in the process of setting up Rural Self Employment/ Entrepreneurship Institutes (e.g. RUDSETIs set up by Syndicate Bank, Canara and Dena Bank, Maha Bank Self Employment Training Institute (MSETI) and Gramin Mahila Va Balak Vikas Mandal set up by Bank of Maharashtra) as separate society/trust for training and capacity building of prospective borrowers. Such societies / trusts can have an exclusive wing which may initially with support of the trainees of the institute undertake the function of Business Facilitators.

Model B : Business Correspondent Model for Financial Services as "Pass Through" Agents

Scope of Activities

3.6 Apart from the facilitation support, it may be possible to use several institutions as agents for providing assistance in financial functions on behalf of banks. Properly identified "Business Correspondents" under contractual arrangement may be allowed to function as "pass through" agents. Besides the functions described under Model A above, the correspondents would provide other value added services, such as, (i) disbursement of small value credit, and (ii) recovery of principal / collection of interest and (iii) sale of micro insurance/mutual fund products/pension products. In respect of all such transactions, the correspondents will be authorised to accept/ deliver cash either at the door step of the customer or any other convenient locations subject to the cap fixed by the parent bank. The Business Correspondents may be monitored closely and based on their satisfactory performance over a period of time, say not less than one year, and subject to the comfort of the bank, they may also provide services like collection of small deposits, receipt and delivery of remittances / other payment instruments, subject to certain limits and compliance with statutory and regulatory requirements in this regard.

Types of Correspondents

3.7 Business Correspondents could be, subject to a process of vigorous screening as detailed later in this Chapter, agencies like registered NBFCs, NGO-MFIs set up under Societies/Trust Act, Section 25 companies, societies under MACS, and Government/ corporate supported IT enabled outlets which already conduct cash transactions on behalf of the corporate entities with appropriate contractual agreement which would bind the principal corporate entity for the action of their field level agents. Another agency as a group that merit attention for being used as the Business Correspondents are the Primary Agricultural Credit Societies (PACS). Though the current state of finances and management of a large number of PACS is a cause of concern, they have deep roots in rural India with experience of financing large numbers of small and marginal farmers for over a century. Hence, it would be worthwhile to leverage the well running PACS both as Business Facilitators/Correspondents to act as intermediaries to increase the outreach of the banking sector in rural areas. For this, a due diligence of the PACS can be

undertaken covering certain critical aspects, such as, (i) an elected board with a broad based membership, (ii) a well defined and transparent loaning policy, (iii) availability of trained staff with knowledge of the local area, (iv) up-to-date accounts, (v) reasonably good financials with recoveries of not less than, say, 70%, (vi) absence of large/long unreconciled amounts in sundry /intermediate heads of accounts, (vii) absence of any major audit observations, and cases of large misappropriation / fraud pending against its office bearers or staff. Organisations like RUDSETIs/ other Trusts/ Societies set up by banks, as mentioned in paragraph 3.5 above, may also be developed to function as Business Correspondents.

3.8 An experiment under the aegis of NABARD is being conducted in a few districts of Tamil Nadu to use the services of post offices for facilitating the SHG Bank linkages. Based on the results, Post Offices/ Postal employees may be considered for both Business Facilitator and Correspondent relationships.

3.9 It will be seen that the arrangements envisaged under Models A and B would go a long way to fill the gaps that exist now. These models have the potential to leverage both the existing network of bank branches on the one side and the plethora of informal and formal agencies engaged with the poor in particular and the rural sector in general to achieve the objectives of expanding the effective outreach of the formal financial system.

Engagement of Business Facilitators/Correspondents : Concerns & Safeguards

3.10 Engagement of outside entities as facilitators /correspondents for providing various services would, however, require satisfactory resolution of number of operational, regulatory and legal issues. In their response, some of the banks and respondents have, in fact, expressed certain apprehensions about the intermediaries to be used under the proposed arrangement, such as: (i) undue exploitation of ill informed poor people, (ii) lack of secular and non-partisan credibility, (iii) increased cost of operations with the introduction of an additional tier, (iv) capability and long term sustainability, (v) lack of integrity and honesty leading to misuse of funds/defalcations/frauds, (vi) poor financial discipline due to local connections, (vii) customer complaints and grievances affecting the image of the bank, (viii) customer

confidentiality, (ix) dilution of KYC norms, (x) improper internal control arising out of delay in accounting and reconciliation and (xi) scope for emergence of staff-agent nexus. Further, banks, who as regulated entities are required to ensure adherence to prudential norms, may be under strain to closely monitor the systemic risks that may arise out of imprudent activities of the facilitators/correspondents, particularly when there is substantial build-up of portfolios through their intermediation.

3.11 Considering the above, some of the key aspects to be kept in view while entering into arrangements with the Business Facilitators/ Business Correspondents are : (a) internal policy for identifying and accepting Business Facilitators /Business Correspondents as outside service providers, (b) the risk management strategies in the banks, (c) the rating of the correspondents, (d) due diligence to be carried out on them, (e) the code of ethics/ fair practices under which the Facilitators/ Correspondents shall operate, and (f) on-going monitoring and review of the arrangement. It may be mentioned that the extent and severity of risks associated with Business Facilitators may be significantly lesser than those associated with Business Correspondents. Hence, while the considerations listed above may be relevant for both Models A and B, the rigour employed for the former may be less. These are discussed briefly in the following paragraphs.

Policy for Identification and Acceptance

3.12 The bank shall have well laid out policies and procedures for identifying and accepting Business Facilitators/ Business Correspondents. The identification process shall be based on, inter-alia, the reputation of the entity, governance structure, capability for proper maintenance of records and accounts, capacity to provide social support to poor and marginalised sections, grass root presence in the area proposed to be served by them and experience of prior relationship with the bank. A due diligence on the key office bearers of the entity, if applicable, is also essential, particularly in case of the Business Correspondents. A specific check on the reputation in terms of commitment, integrity and competency in the local area where the entity would perform shall be a key element. The sources of funds, if any of the entity, its deployment, etc. should also be examined.

3.13 The banks may establish criteria for selecting the Business Facilitators/ Correspondents through a Board approved policy which may expressly state the strategic reasons and the perceived benefits for establishing such relationships. One major criteria may be the incremental outreach that it may gain so that hitherto unbanked people can be served. Such an approach shall help in monitoring the costs in maintaining the arrangement.

Criteria for Identification

3.14 The banks are expected to evolve their own criteria for the purpose. Based on feedback from member banks, the Indian Banks' Association (IBA) may also evolve certain benchmarks in this regard. Experience in dealing with Direct Selling Agents in retail loans of banks may also prove useful in this regard. An indicative set of criteria for identification of the Business Facilitators/Correspondents are given below.

(A) Business Facilitators

- i. The bank may carry out due diligence on the Business Facilitators.
- ii. The facilitator should be referred by at least two persons known to the bank in case of an individual or have a proven track record, if it is an organisation so as to ensure that they have the aptitude and capability to perform the role of Business Facilitators.
- iii. Persons/ organisations with satisfactory dealings with banks may be preferred.
- iv. Minimum eligibility criteria may be fixed, such as, education, age, knowledge of local area, language, non-affiliation with political/ religious organizations and absence of any criminal record as verified from the police authorities in the case of individuals/ persons managing the organisations.

(B) Business Correspondents

- i. Agencies should have significant rural presence.
- ii. Well-regulated entities may be preferred initially. However, other entities as referred to in para 3.7 above may be considered in their absence.

- iii. The entity should have a satisfactory track record. Banks may take the help of organizations like NABARD, SIDBI, Association of MFIs, the Council for Advancement of Peoples' Action and Rural Technology (CAPART), etc. for obtaining the list of such NGOs who are active in their areas of operation.
- iv. The bank may carry out a process of vigorous screening including due diligence and rating as described in detail in this Chapter before engaging Business Correspondents.

3.15 The institutions/persons to be engaged as Business Facilitators and Business Correspondents shall enter into a formal contractual relationship with the bank, which shall explicitly detail the functions that they shall undertake on behalf of the bank, the precise terms and scope of the services, compensation, etc. The contract shall include rights, responsibilities and expectations of all parties, including the compensation structure and shall include an enabling clauses for the principal (i.e. the bank) to access the records of such entities, particularly in the case of Business Correspondents, wherever considered necessary. A list of "DOs" and "DON'Ts" may also be annexed to the contract. The contract shall be legally enforceable, and shall contain termination clauses. The contract may provide for voluntary supervision by the principal bank as explained later in this Chapter.

3.16 The banks shall establish a system of watching the performance of accounts brought in by such agencies and shall rate agencies on the basis of the performance of the accounts. These assessment parameters shall include the remoteness of the accounts brought in, the types of client, the regularity of savings/credit usage and repayments, upkeep of records, etc.

3.17 In the case of Business Correspondents, they shall be required to submit periodical reports to the bank. While the reporting rigour may have to be kept easy and minimal, the regularity and completeness of the same shall be kept as important factor for continuing the relationship.

Risk Management

3.18 The Joint Forum constituted by the Bank for International Settlements⁵ has identified several key risks in outsourcing arrangements. Based on this and the available literature, some of the risks and other major concerns are discussed below.

3.19 The banks may face **Legal and Reputation Risks** due to the poor service from third party customer interactions not consistent with overall standards of the bank, wrong doings of the facilitators/correspondents, misuse of bank's stationery, logo and brand name etc. Likely **Operational Risks** are those relating to technology failure, fraud or error, technology risk relating to penetration into banks' data domain where online technologies are used, risk that banks may find it difficult/costly to undertake inspections and risk arising out of benami/fictitious transactions or "ghost" accounts created by the Business Correspondents. Some of the other risks are contractual risk, legal risk like inadequate documentation, integrity/fidelity risk etc.

3.20 The entire risks involved, which may include temporary financial exposure among others, depending on level of technology adopted, shall be wholly borne by the banks. The banks can indeed hedge the same by accepting collateral security or taking appropriate insurance cover including fidelity insurance against likely losses if such products are available or can be developed.

3.21 The bank may have appropriate checks and controls to take care of risks emanating from these arrangements. The Bank's internal policy shall examine the risks associated with the arrangements and put in place detailed operational guidelines to take care of the same. The reputational, financial and fidelity risks involved has to be assessed and managed by the banks through a process of formal rating of institutions that will act as the support system.

3.22 Some of the elements of checks and controls that are required for risk management are (i) a well defined contractual arrangement as explained above between the principal (i.e. the bank) and the Business Correspondent, (ii) provision of maximum cash limits both in terms of per client and per day transactions keeping

in view, among others, the economic profile of the area, seasonality factors, track record of the Business Correspondent, etc. (iii) system of taking security deposit, (iv) incentives for performance including coverage of special target groups like women, SC/ST, marginal farmers, poor, etc., (v) surprise checks, (vi) loan delinquency history mapping, (vii) audit /inspection, (viii) delinquency liability (First Loss Default Guarantee-FLDG) and (ix) exposure limits (prudent exposure limit may be prescribed for the size of the portfolio that may be built up through the Business Correspondents).

Exposure Monitoring

3.23 As a concentration risk management measure banks may fix suitable exposure limits which may be reviewed periodically on the basis of business developed through Business Correspondents collectively as well as individually.

3.24 It is recommended that the portfolios developed through the Business Correspondents may be segregated as easily identifiable in the bank's books/IT systems. The portfolio shall be readily available for supervision and monitoring and for statistical compilations. This approach shall enable banks to bring in necessary controls and checks and facilitate risk management in the long run.

Rating

3.25 The banks may take steps to rate the Business Correspondents and only well rated agencies may be engaged. In the case of MFIs, the rating may be undertaken by independent rating agencies. Some of the major parameters to be covered under the rating are given in **Annex 3.1**. The type and extent of the business relationship shall determine the acceptable levels of rating which may be decided by the respective banks. A brief analysis of the rating of MFIs who could be potential Business Correspondents are given in **Chapter 4**.

Standards for Due Diligence

3.26 The Business Correspondent relationship shall have two entities requiring due diligence; (a) the Business Correspondent itself and (b) the non face-to-face

⁵ Working Group of the Joint Forum constituted by the Bank for International Settlements on Outsourcing in Financial Services : February 2005.

customers sponsored by the correspondents. It is, therefore, necessary to do a thorough due diligence on the outside service provider for which benchmark standards need to be developed. The banks, which are well regulated, overseen and supervised should be subjected to regulatory and supervisory scrutiny on their system and process of due diligence in this regard.

3.27 While setting standards for due diligence, the recommendations of the Basel Committee on Banking Supervision and the experience of Direct Selling Agents (DSAs) already engaged by some banks, may be borne in mind. Some indicative parameters for due diligence have been included in **Annex 3.2**.

Code of Ethics

3.28 The ethical dimension is brought in to take on board the social preparatory/reengineering work that is required in the efforts to reach out to the poor. The organisations involved in this need to have a commitment for social action and capacity building, shall be non-discriminative, secular, non-exploitative, transparent and have good governance structure. It is suggested that the banks may hold on record a statement of code of ethics and periodically monitor the same to ensure that the entity subscribe to it.

Fair Practices Code

3.29 It is advisable to establish a Fair Practices Code for all Business Correspondents. The modalities for establishing the same will have to be worked out through a consultative process amongst the banks. The broad parameters to be contained in the Fair Practices Code shall include good governance practices, transparency in accounting and pricing, appropriate disclosures and a mechanism to periodically share best practices amongst the various institutions.

3.30 In the case of MFIs, a well represented central body or State Level Associations can take up the responsibility of framing the codes & standards and ensuring its adherence.

Compensation Package

3.31 The bank shall provide reasonable fee to the agency involved based on the services provided. Performance based incentives/ penalties may be built. The Business Facilitator/Correspondent **may not** be allowed to charge a service charge

from the client. The total burden on the client including the rate of interest and the overall compensation package of the Business Facilitator/ Correspondent shall not result in usurious rates.

Monitoring & Capacity Building

3.32 The bank may adopt a graduated monitoring mechanism on a tapering scale over time wherein the Business Facilitators/Business Correspondents shall work under close monitoring system for at least one year. The monitoring of the arrangements may be done at reasonably senior levels, i.e., Regional / Zonal office of the bank concerned. During the initial phase the bank may provide handholding and capacity building support, if needed, to such facilitators/correspondents. Crash training courses may be arranged for the purpose by the banks. Hand Books/Guide Books giving detailed prudential guidelines may also be prepared for the use by the facilitators/correspondents. For example, a simple format for data collection and credit scoring model may help in preliminary appraisal of the loan proposals.

Voluntary Supervision

3.33 Though the Business Correspondents do not carry the assets and liabilities originated by them in their balance sheets, banks are exposed to them in various degrees, depending on the volume of business handled and the system and procedure followed in reporting and accounting of the transactions. Risks emanating from such arrangement have been described above. It is, therefore, suggested that these entities voluntarily offer themselves for supervision by the principal banker. The practice prevalent in the SCARDBs and PCARDBs is an example where they are subjected to prudential norms and voluntary inspection by NABARD. A similar voluntary approach is recommended.

Customers Choice

3.34 The customers shall have the freedom to use branch banking facilities even though the Business Correspondents are available in their locality or they were initially sponsored by the Correspondents. This is considered necessary as absence of such choice to deal directly with the bank may lead to over dependence of clients on intermediaries for availing of banking services and complacency on the part of bank employees for business development.

Redressal Mechanism

3.35 A common redressal mechanism may be put in place with representations from various stakeholders for quick and efficient resolution of complaints and grievances. Banks may formulate an internal scheme similar to the Banking Ombudsman for this purpose. Such scheme should be given adequate publicity.

Outreach Development – Encouragement and Publicity

3.36 The banks may take proactive decisions to increase outreach to underserved areas/unbanked persons. Appropriate targets may be fixed internally and monitored. Branch/field level functionaries of the banks as well as Business Correspondents/Facilitators may be acknowledged and awarded for achieving greater outreach, improving asset quality and including disadvantaged sections under the arrangement. Measures to widely publicise the proposed arrangements may be taken up by the banks and other agencies concerned.

Regulatory Clearance and Forbearance

3.37 To facilitate linkages between the formal banking system and the various agencies working as the Business Facilitators and the Business Correspondents for delivery of financial services in rural area, certain regulatory forbearance/relaxations may be required as briefly discussed below :

(a) Permission to Engage Business Facilitators / Correspondents

Banks are required to seek clearance from RBI to undertake such arrangements involving (i) payment of commission, fees, etc. to the Business Facilitators / Correspondents, and (ii) conduct of certain types of banking business through them at places other than the branches of the banks. The Group recommends that while

RBI may issue general permission / clarificatory circular in respect of (i), in the case of (ii), it may accord necessary permission to banks to conduct such business when approached in this regard.

(b) KYC Norms

The use of Business Correspondents would entail the expansion of customer base with large numbers of non face-to-face customers. Considering the need to provide banking services to the under-serviced rural people of small means, RBI may examine relaxing/simplifying the documentation requirements in respect of accounts of rural poor opened through the channels of the Business Correspondents. Such relaxation may apply to accounts with transactions upto a limited extent, say Rs. 100,000 per year.

3.38 Incorporating the broad guidelines indicated above, RBI may advise the banks to take effective steps to engage the Business Facilitators/ Correspondents. Banks and the IBA may be requested to study the issues and problems which may arise during the transitional phase of implementation of these two Models and take up the matter with RBI and others concerned for issue of further guidelines and clarifications considered necessary.

National Microfinance Information Bureau (NMIB)

3.39 Under the Business Facilitator and Business Correspondent Models, banks are expected to use large number of entities as agents. It is therefore appropriate to warehouse the information of all such agencies and share the data among all the banks involved. In addition to this, it is also important to collect and store data on the clients serviced through the suggested models. It is suggested that a National Microfinance Information Bureau (NMIB) under the aegis of NABARD may be established for this purpose. NABARD with the help of CIBIL and SIDBI may be requested to examine the operational aspects involved in this.

3.40 In the meanwhile, efforts may be made to immediately capture and share the data/information on the 800 plus MFIs involved in lending to the poor and 3000 plus NGOs associated with the SHG Bank linkage programme & other models of bank / MFI linkages by NABARD.

Bank – Business Facilitator / Correspondent Relationship

3.41 The Business Facilitators / Business Correspondents shall have the contractual relationship with only with one bank in a defined geographical area to avoid malpractices and ensure customer confidentiality. This will facilitate a close monitoring of their performance by the banks concerned. Eligible entities can, however, have relationship with different banks in different areas. In addition, the NMIB shall also provide information on the relationship between the banks and the service providers. Intimations regarding termination / cancellation of such arrangements by banks due to negligent or fraudulent actions by the Facilitators/Correspondents may also be collated by this Bureau and circulated among banks.

Expanding Outreach - Existing Models and Institutions

SHG Bank Linkage and Bulk Lending to MFI Models

3.42 Besides the two models recommended above, as already described in **Chapter 2**, the model of SHG-Bank linkage programme and the rapidly emerging models of financial intermediation arrangements involving (i) bulk lending to MFIs by banks/apex financial institutions [e.g. SIDBI Foundation for Micro Finance (SFMF) and Rashtriya Mahila Kosh (RMK)] for on lending, and (ii) build-up of micro finance retail portfolios under Bank - MFI partnership model need to be pursued by the banks more vigorously. Some measures, which will facilitate further expansion of bank credit through these models, have been discussed in **Chapter 4**.

3.43 The PACS and RRBs merit special mention as they have a very large size of micro finance portfolios and have the potential for exponential growth in rural credit and micro finance given their vast infrastructure and reach in rural areas. While the scope of utilizing well running PACS as Business Facilitators/Correspondents under Models A and B has been described in earlier part of this Chapter, it is necessary to seriously examine and implement the recommendations of the Task Force on Revival of Cooperative Credit Institutions (Vaidyanathan Committee) (2005) in a time bound manner for revitalization of the PACS. In respect of RRBs, several initiatives including the recommendations of the Internal Working Group on RRBs (May 2005),

which are under way to make them vibrant and viable rural financial institutions, may be carried forward with utmost speed.

3.44 Banks may also explore possibilities of establishing relationship with other banks for extending their services/ outreach to derive synergies by mitigating difficulties, such as, absence of physical presence, lack of appraisal capabilities, inadequacy of financial resources, etc.

Chapter 4

MFIs/ Other Outreach Entities: Promotion, Development and Rating

4.1 The recommendations contained herein flow from **Chapter 3**, which envisions leveraging MFIs, CSOs, NGOs, Cooperatives, individuals and corporate retail outlets for widening the reach of financial services in rural India.

4.2 It is necessary to create an enabling environment for the rural financial market development so that more agencies are available resulting in efficiency through market driven control on price and quality. As the markets mature and more players enter, competition would result in re-pricing the products and with further maturity, the differentiation would move to product innovation to meet the unique requirements of various market segments.

4.3 Recognizing the need for deeper penetration of financial services in the rural areas and reaching them to the poor, the challenge is of planting MFIs and similar such institutions in regions that are virgin territories. There are several options that exist, such as, expanding the coverage of existing MFIs to new territories, migration of local NGOs to become MFIs, hiving off the micro finance operations of NGOs into an MFI and encouraging local enterprising individuals and bodies with a developmental and social focus to promote MFIs.

Promoting MFIs

4.4 All or any of the suggested initiatives will require support since the natural evolution process will take time and the overriding concern today is of reaching financial services to the poor as quickly as possible. It is, therefore, necessary to support such initiatives externally through capacity building and financial assistance.

Financial Support to MFIs

4.5 MFIs being financial intermediaries will require start-up capital of a significant order to be able to leverage and attract loan funds from the banking system. They however have serious limitations in raising such funds. The "Micro Finance

Development and Equity Fund" (MFDEF) would require to play the critical role of providing Equity Capital or Quasi Equity to enhance the capacity of the MFI to undertake financial operations and enhance the comfort level of the lenders.

Sourcing International Funds for MFIs

4.6 At present the capitalisation norms fixed for FDI in NBFC sector is USD 500,000 (about Rs.2.18 crore at current exchange rate) for investment upto 51% of the equity capital and the minimum amount further increases to USD 7.5 mn if stake upto 100% is desired. In the case of NBFC-MFIs the entry level capital has been prescribed at Rs. 2 crore,. A foreign investor who is willing to put in smaller amount in the microfinance sector to gain some experience may find such norms financially unattractive. To encourage foreign equity participation in NBFCs so that they are able to meet the entry level capital requirements, particularly in those areas where the spread of MFIs have not been encouraging, it is suggested that the minimum FDI requirement may be lowered to USD 100,000 (about Rs. 44.00 lakh). Alternately, such liberal dispensation may be considered for investments by NRIs only in this sector.

Direct Finance Facility to MFIs

4.7 The micro credit portfolio of the regulated MFIs may be made eligible for direct finance from NABARD so that their resource base is augmented, they are incentivised to scale up the micro finance portfolio, and it would mean reduction in their cost of funds leading to lowering of the interest rate for the ultimate borrowers.

Risk Mitigation

4.8 (i) *Liquidity Support:* MFIs, due to the covariant nature of credit risk, may need liquidity assistance in case of large-scale defaults and if loans have to be rescheduled/rephased on account of calamities/crop failures, etc. NABARD may offer a special line of credit to take care of such eventualities.

(ii) *Insurance :* Insurance Regulatory and Development Authority (IRDA) in consultation with NABARD, SIDBI, MFI Associations, IBA and private/public sector insurance companies may examine in detail the scope of expanding the existing micro-insurance schemes and introduction of other innovative insurance products

including group insurance to take care of the risks faced by the SHGs/micro entrepreneurs as well as the lending banks.

Capacity Building

4.9 Capacity building is going to be essential for the large number of NGOs/MFIs that are necessarily required to be promoted to expand the geographical coverage of finance services. Due to the unique features of each region, it would be preferable to have geographically localised MFIs manned by people with a good understanding of the local region and its peculiarities. Capacity building would require both training at the level of professionals and the field staff. For professionals, the options could be increased by preferential intakes at institutions like the TATA - Dhan Academy and the Indian School of Micro Finance for candidates from the identified areas with financial support from MFDEF to meet their training cost with a service bond. Training could also be in the nature of secondment to established MFIs for on-the-job training. Resource institutions like Sa-Dhan could coordinate such initiatives.

4.10 National level training Institutions like the College of Agricultural Banking (CAB), Pune and the Bankers Institute of Rural Development (BIRD), Lucknow may develop suitable training modules for senior and middle level executives and trainers of MFIs. These institutions may also provide a platform for periodic interactions among MFIs, banks and others concerned including the industry associations for cross learning and a forum for interface with policy makers and regulating authorities.

Promoting Bank-MFI Bulk Lending Model

4.11 Under the Bulk Lending to NGO-MFI model an aggregate amount is placed with the NGO-MFI by the lending institution as a term loan or as a facility out of which the MFI draws funds for on-lending to SHGs or individuals. This model largely transfers the entire functions of appraisal, operation and maintenance of accounts to the MFI. This has its own advantages and could be appropriate for MFIs which have a federal structure. The first option for sourcing funds for bulk lending should be banks but other apex institutions like NABARD and SIDBI may also extend the facility to start-up MFIs. Large part of funds lying with State/ Central level Development/ Finance Corporations, if feasible, may also be channelised through

NABARD to identified MFIs for effective flow of funds to the target groups and in the process reducing the overall cost of funds of the MFIs. Further, where capital for leveraging funds is a constraint equity support may be considered under MFEDF following an in-depth evaluation process. It is observed that in the absence of large number of reputed MFIs, many banks are lending to only a few MFIs under this model, partly to meet their priority sector lending obligations. There is, however, no exchange of information among the lending bankers and this may expose them to several risks including over financing. It is, therefore, suggested that banks may consider encouraging a "consortium" approach for such financial arrangements.

Promoting Bank-MFI Partnership Model

4.12 As described in **Chapter 2** (para 2.20) and **Annex 2.1**, the Partnership Model has potential of expanding the outreach of banks, particularly those having limited branch network. There are, however, a few concerns and issues, as mentioned below, which need to be addressed to enable this Model to operate efficiently, viz. (i) misgivings in the minds of banks who are inclined to experiment this arrangement about the regulatory and supervisory issues, (ii) lack of clarity with regard to the rights and obligations of the MFIs *vis-à-vis* the banks since although the MFI is responsible to ensure recovery of loan, the loan documents are executed by the ultimate borrowers in favour of the bank, (iii) maturity mismatch between the repayment schedule drawn by the bank *vis-à-vis* the MFI and the repayment schedule between the ultimate borrowers and the MFI, (iv) the amount of fixed deposits collected as margin from the MFI by the bank is often beyond the financial capability of the MFI, this is particularly so in respect of Section 25 companies, (v) imprudent selection of MFI as partner in a bid to build up portfolio rapidly, and (vi) risk of multiple financing by more than one bank.

4.13 In the circumstances, IBA may be requested to study the scheme in detail and based on feedback from the banks, it may prepare and circulate a model scheme among the banks in consultation with RBI.

Future Growth of SHG Bank Linkage Model

4.14 The main challenges facing the SHG-Bank Linkage model are: the pace of expansion of the programme, the limited number of NGOs in regions where the

programme has not picked up momentum, the cost of promotion for NGOs not being fully met by donors and banks, the per capita credit outlays being very small and not commensurate with the costs involved in bringing the SHGs to the banking mainstream and overloading of SHGs with multiple agenda, particularly government sponsored programmes. RBI and Government, as a part of their developmental role, NABARD, which is spearheading this programme, and banks who are the main promoters of the programme, may initiate effective steps to overcome these shortcomings.

Promotion of Federation Structure

4.15 The long-term sustainability of the SHG model may require a federal structure without severing the linkages that the SHGs have with the local bank branches. Only specialised loans and services like rural housing loans and insurance may be offered through the federation structure. Such federations may also improve the quality of the SHGs by tying up with independent service providers for accounts and audit, business development and capacity building besides facilitating credit linkages with banks.

4.16 The assumption that the federation structure should not be supplanted on the SHGs and such requirement can be addressed when the demand emerges needs reconsideration. NABARD being the key driver of the SHG movement may like to plan for the federated structures for SHGs. Support may be extended from MFDEF for meeting the start-up costs of establishing such federations and initial period operational costs.

Incentives to MFIs and NGOs for maintenance of SHGs

4.17 So far the attention has been more in the realm of promotion of SHGs. However, an equally important task is that of maintaining the groups beyond the early growth phase. There is urgent need to continue providing some financial support to NGOs to maintain reasonable level of nurturing and monitoring of the SHGs promoted by them. Such funding may come partly from the MFDEF and partly from the subsidy funds of Government.

Developing Standards of Accounting for SHGs and NGOs

4.18 While accounting systems of MFIs are fairly well developed, there are no prescribed standards of accounting for SHGs and NGOs. It is suggested that standards for accounting practices may be developed by NABARD in consultation with the Institute of Chartered Accountant of India (ICAI). Audit Standards of NGOs in the micro finance sector also needs to be codified, standardised and professionalised. This could be undertaken by NABARD as a promotional initiative.

Maintenance of a National Database on SHGs and MFIs

4.19 At present, NABARD is maintaining the database on SHGs. It publishes Annual Handbook on microfinance in India with focus only on SHG-Bank linkage programmes. Thus, it does not take into account Grameen and many other alternate models in the statistics. Sa-Dhan is publishing data on MFIs but it does not cover the data of all operating MFIs. It is suggested that NABARD be assigned the responsibility of collection of data involving the entire sector, their compilation and dissemination.

Contributions to the MFDEF by banks

4.20 Given the several demands that would come on MFDEF, the Group suggests that its corpus be built up on an ongoing basis. A portion of the profits of the banks may be contributed to the fund. The Government may consider allowing banks to charge the contributions made by banks as a tax-deductible business expense. Government could also consider sharing a part of the dividend that it gets on the equity it holds in banks by contributing towards this fund. Another suggestion offered at various fora has been that a portion of the Government of India, Ministry of Rural Development funds for capacity building be made available to NGOs and MFIs to meet capacity building expenditure through MFDEF.

Role of Corporate Sector in Micro Finance

4.21 Corporate India has, of late, shown keen interest in the SHG movement as it provides an alternative business opportunity for them besides being a means to actualise its corporate social responsibility objectives. As the poor move from subsistence living to higher standards of living, their demand for newer goods and

services besides the traditional items like agri-inputs implements and household consumables grows rapidly. Many corporates have realised that the people at the bottom of the pyramid can be brought into their business model. The Group also sees a critical role of the corporate sector in providing market linkage to the products of the rural areas on a sustainable basis. Currently corporate outfits like the ITC (through e-Choupal), HLL (through Stree Shakti Project), Mahindra & Mahindra (through Mahindra Subha Labh) and Tata Group (through Tata Kisan Sansar) are providing these linkages for food grains, oilseeds, agri inputs and FMCGs besides dissemination of information useful to the farmers. One can foresee a scenario where processing and packaging of many products marketed by the corporates would also shift to the village level due to cost and economy factors. Further, even activities for mass production goods could be undertaken in the rural areas. Opportunities also exist for transfer of technology by the large corporates to village level enterprises. Banks may consider to link up with such corporate initiatives. Illustrative flow chart of possible uses of corporate-bank linkages is given in **Annex 4.2**.

Demonstration SHGs/Resource Centres

4.22 Some of the NGOs and SHGs have developed matured and organised systems of operations and are in a position to act as resource centers not only for the nearby groups but also even on a state and national basis. It is suggested that support from MFDEF may be provided for development of infrastructure by such identified resource centers.

Promotion of Farmers' Clubs

4.23 SHGs have largely been identified with women. Men are equally important to carry forward the development process. The NABARD Farmers' Club programme has been operating on a very limited scale. It is suggested that the Farmers' Club movement be broad based by including the extension departments of the Agricultural Universities, Agriculture Departments, Research Stations, etc. Private sector corporate houses that have entered into this area, such as, ITC – E-Choupal, Mahindra Shubh-Labh may also be roped in to broad base the Farmers' Club programmes. This would also pave way for contract farming as some of these corporate houses are either the consumers of the farm produce or engaged in the

marketing of the same. NABARD may initiate necessary steps in this regard. It is suggested that these clubs may be registered as societies / trusts etc so that they can enter into contracts with banks to function as Business Correspondents.

Development of Micro Enterprises

4.24 As SHGs grow from meeting the subsistence needs of its members to building up significant corpus, a major roadblock being faced by them is inadequate information and knowledge on the appropriate economic activities that they could undertake. Mapping potential activities requires professional study. It is therefore suggested that either Association of NGOs or apex agencies like NABARD and SIDBI undertake detailed potential assessment of suitable economic activities for each area and widely disseminate this information. Further, promotional institutions in the area may undertake collaborative initiatives such as organising Rural Entrepreneurship Development Programmes (REDPs) and market support for such economic activities. The Government institutions and other technical agencies may also be roped into such endeavours so that there is synergy and the whole activity develops critical mass and economies of scale. Funding support for such activity may be provided from MFDEF.

Extending Outreach using ICT

4.25 One major reason for growth of microfinance institutions (MFIs) is on account of continuous decline of profit margins of the banks and financial institutions that forced them to extend their services through MFIs while at the same time reducing transactions costs. Recent experiences suggest that the innovative use of existing technologies, such as, automated teller machines (ATMs), smart cards, Personal Digital Assistants (PDAs), mobile phone technologies, simputers and remote transaction services can significantly expand the customer reach, improve quality of service and customer satisfaction, increase data collection and analysis, and reduce transactions costs. It may be noted that the widespread use of Information and Communication Technology (ICT) will increase when it becomes easier, more convenient, cost effective, reliable, and secure for the consumers. Though each delivery technology provides significant benefits, banks need to undertake in-depth cost benefit analysis and study of availability of supportive infrastructure and the

technology familiarity, language preferences and literacy of the clients before choosing a technological solution for applying in rural areas. A summary of select technical solutions available for extending the outreach of the banking channels with focus on customer convenience is given in **Annex 4.1**.

4.26 Keeping in view the above and to enable banks to function effectively through MFIs/other outreach entities in rural areas, the following ICT initiatives may be undertaken by the concerned agencies.

4.27 Rural Kiosks/ Village Knowledge Centers may be set up in rural areas. In this connection, it may be noted that in the Union Budget Speech for 2005-06, the Finance Minister has declared the goal of setting up Knowledge Centre in every village by 2007 through joint efforts of the Government and a number of other organisations. He has also indicated that Rs.100 crore may be provided by NABARD from RIDF for this purpose. The remaining cost may be borne by State/Central Governments on a shared basis.

4.28 Such kiosks can also be set up by extending loans to PCO booth owners or other eligible persons in a village by banks. The information should be available in local languages with voice facility. A detailed action plan in this regard may be chalked out by the Government of India, Ministry of Information Technology in consultation with other relevant agencies.

4.29 On account of heavy migration of rural people to urban areas there is an immediate need to enable them to remit their surplus to their family members at rural area on an easy term. The INFINET payment system backbone may be expanded to cover rural areas to enable banks to have an efficient, low cost and secured money transfer and settlement system in place using MFIs/other eligible outfits as conduits.

4.30 NABARD may set up a NGO-MFI gateway website in all Indian languages for having information relating to NGOs and MFIs which will act as a resource center for existing and new NGO-MFIs. IDRBT may be requested to examine, in consultation with NABARD, the feasibility of setting up a portal to enable e-marketing of products of SHGs/ micro entrepreneurs by making use of rural kiosks, Village Knowledge Centres, etc. Over time, the settlement can be web enabled by linking the portal

with the payment gateways of banks financing the concerned SHGs/micro entrepreneurs.

4.31 A Rural Banking Technology Development Fund (RBTDF) may be set up by way of grants from Government of India, NABARD and international donor agencies with an initial corpus of Rs.5 crore. The resources of the Fund could be utilised to enable banks, particularly RRBs and cooperative banks, to computerise their operations and build network capabilities. The technology infrastructure cost met by banks in rural areas and contribution made by banks to proposed RBTDF may be included for computation of bank's target for priority sector advance.

4.32 It is necessary to test the technological solutions before putting into use to meet any kind of technology related risks. Hence, IDRBT may design and test low cost and secured technological solutions for financial sectors and thereafter disseminate them for wider use. Further, research on newer technologies can be outsourced involving reputed IT companies with venture capital support. On successful incubation, the technology can be patented and commercialised through interested IT companies.

4.33 Many banks are already using innovative technologies to expand their reach to extend banking facilities to unbanked areas. NABARD and IBA may make efforts to bring these initiatives to the notice of other banks, NGOs and other stakeholders through their websites, brochures, house journals, holding seminars and demonstrations of such technologies at frequent intervals. NGOs may also be encouraged to educate people regarding use of technology for transacting banking business and how to retrieve information from kiosks and village knowledge centers.

4.34 As customer base of the banks increases through the intermediation of MFIs, it is necessary to have suitable centralised monitoring system in place by the banks so that they can effectively monitor various accounts and escalate alert to branches/their business correspondents. It is, therefore, necessary for all categories of banks to have centralised database systems as part of Core Banking Solutions (CBS) in place in a medium term. Such centralised database system would help the banks to have an effective MIS and enable them to meet the increased demand of customers for availing of newer products and facilities.

Promoting Micro Finance in the North East

4.35 The North East Region (NER) does not differ very much from the rest of the country in terms of the financial needs of the poor. They need lump sums at regular intervals to meet their production and consumption needs. However, these requirements have not been met adequately by the banking system either through SHG linkage programme or otherwise. The main reasons for such unmet demand are lack of manpower, unfamiliarity of the staff with the local environment and culture due to short tenure and absence of adequate branch network. A distinctive feature of NER, however, is that it has an economically active women population that has been involved both in agriculture and rural non-farm sector. Though NER also has islands of vibrant micro enterprises, especially in the valley region, almost all their financial needs are micro in nature. There are also examples of local institutions like Marup in Manipur, Village Development Boards in Nagaland, Village Durbar in Meghalaya and Kebang in Arunachal Pradesh which provide social capital. In other parts of the country, there are a large number of NGOs involved in social activities that could take up the micro finance activity of group formation and nurturing as an add-on activity so that the costs of forming and nurturing groups could be absorbed by NGOs from their other operations. This is not possible in NER since the NGO movement is still in the nascent stage and the NGOs do not have funds for taking up microfinance activity in an efficient manner. Given the large information asymmetry because of multiplicity of tribes, NGO/MFIs from the locality are best suited to provide the services at minimum costs.

4.36 Capacity building of these entities and the resources for it are a major issue. There can also be a Social Venture Fund that can support the growth of NGOs/ MFIs and facilitate innovations that are more conducive to the needs of the NER. The North East Council (NEC) in collaboration with NABARD would be the most appropriate place for this fund since its mandate is the development of NER. The NEC may also coordinate for creating a network of NGOs working in the North East. A Risk Fund could also be set up to induce financing agencies to extend micro finance to activities considered very risky.

Rating of Micro Finance Institutions

4.37 Rating of MFIs plays an important role in the development of the sector and their integration into the financial system. The major parameters for rating are

divided into Non-Financial Parameters and Financial Parameters as have been described in **Annex 3.1**. The rating of the MFIs serves two purposes, one is the absolute use of rating so as to arrive at a funding decision and the other is to compare institutions. While the Group recommends rating of MFIs so as to help banks/ financial institutions decide about engaging them as their agents and funding them, it has also examined several issues relating to the rating process which are discussed below.

Non-Financial Parameters

4.38 These parameters relate to governance, management, systems and procedures, organisation structure, information system, client assessment, etc. Since the MFIs are established under widely varying legal forms, several of these parameters also vary significantly among institutions. Another issue is the transparency, availability and authenticity of the information available.

Financial Parameters

4.39 Generally the financial parameters on which MFIs are rated include capital adequacy, asset quality, earnings, liquidity, etc. In this context, many MFIs operate on a development philosophy as non-profit organisations and, hence, do not pay much attention to earnings and pricing. Hence, the set of non-financial parameters and financial parameters is likely to have a vastly different ratings in a pro-development, people based organisation and a professionally managed "for profit" MFI. Further, financial assessment is dependant on standardised accounting practices and disclosure norms combined with standards for audit.

4.40 Thus, the rating of micro finance institutions have to capture the non-financial, financial and development parameters relevant to the sector. The quality and extent of information available on such parameters required for rating is, however, not uniform. This has led to some critics say that the comparisons based on rating of MFIs is like the proverbial comparison between apples and mangoes. Considering the complexity of the situation and the need for comparable sets of data, quality of information and the transparency and disclosures required, the Group recommends that the rating may be supported by the evolution of standard accounting practices to be followed by all MFIs under any legal form. Standard practices of governance

including well defined goals and objectives, transparency in pricing, etc. have to be established through the initiatives of MFI associations with support from NABARD and SIDBI.

4.41 In order to achieve the above, it is recommended that standard accounting and audit norms may be set for the MFIs. The rating agencies need to be accredited by an appropriate authority and the responsibility may be vested with the proposed National Microfinance Information Bureau (NMIB), brief features of which have been described in **Chapter 3** or alternatively with NABARD.

4.42 Steps need to be taken to increase the number of rating agencies considering the large number of MFIs that are operating in the country. It is recommended that NABARD, SIDBI, and major banks may consider promoting independent rating agencies by way of equity contributions. It is also recommended that financial support may be provided to the accredited rating agencies to cover their operational deficits for a period of three to five years and the expenses in this regard may be met from MFDEF.

4.43 As the MFI assets are typically short term and unsecured, the loan repayments can be very volatile leading to serious deterioration of the asset quality and thereby the financial position over short period of time. This calls for a regular reporting of key performance parameters, at very short term intervals of say one month by MFIs and an ongoing system of updation of the rating by the rating agencies.

4.44 While developing standards of rating major consideration may be the development of a peer group concept which may be based on size, clientele, area of coverage, the core management objectives, etc. It is also necessary to evolve standards and benchmarks for various rating criteria based on temporal data, accepted standards in the financial system, and the contextual requirement in the Indian microfinance sector like special focus on less developed areas, involvement with socially disadvantaged sections, etc. The definitions and indicators have also to be clarified and standardised.

4.45 A comparative analysis of the various rating models reveal that different sets of key indicators/parameters with different emphasis/objectives are used by different

rating agencies. A comparative statement on various international and national models is given in **Annex 4.3**. To have a comparison of ratings and to arrive at minimum commonly acceptable ratings, it is necessary to have a common minimum set of key parameters and objectives as well as methodologies for rating, while additional set of parameters and more evolved methodologies may be employed by rating agencies.

4.46 It is suggested that a comprehensive study of different rating models and methodologies may be conducted and suitable standard of rating established for MFIs in India. Keeping in mind the cost and effort involved in developing an appropriate rating model, the Group is of the opinion that NABARD is the appropriate agency for developing a suitable rating model in consultation with CRISIL, MCRIL, SIDBI and MFI associations.

4.47 The rating process that the MFIs have to undergo periodically is exhaustive, rigorous and, therefore, very costly. As most of the MFIs have not attained financial self-sufficiency, financial support may be extended from out of the MFDEF of NABARD and SFMC of SIDBI to meet part or full cost of rating, as found necessary. Ratings which are done with MFDEF (NABARD) / SFMC (SIDBI) funding should be available in public domain. NABARD may make available the rating information to the banks at their Head Office/ Regional Offices.

Classification of Microfinance Institutions

4.48 The Group discussed the question of classification at some length. The MFIs in India can be segregated into different classifications. Some of these are classification based on profit objective (for profit and not for profit MFIs), that based on the legal form (NBFCs, cooperative societies, charitable societies, trusts etc), type of activities undertaken (deposit taking, credit only MFIs, facilitation only, etc), size of capital funds and size and geographical spread of operations, incidence of regulation and supervision, etc.

4.49 Considering the complexity of the prevailing situation in terms of the types of entities involved, it will be both difficult and may be functionally infructuous to classify the MFIs. Under the circumstances, it is suggested that classification of MFIs may

not be attempted. The banks/ financial institutions should depend on the ratings and due diligence of MFIs to decide on the type and extent of exposure that they may have.

Chapter 5

MFIs & Other Outreach Entities : Regulatory Issues and Concerns

Overview

5.1 The concerns regarding regulation of Micro Finance Institutions (MFIs) engaged considerable time and attention of the Group. India has a unique status when it comes to micro finance regulation and supervision. With the involvement of the formal banking sector, mainly by way of linkages with SHGs under different models and large MFIs being registered as NBFCs, a major share of micro finance portfolio is a part of the prudential regulatory and supervisory framework of the RBI. Insofar as SHGs are concerned, in view of the limited size of their membership, small volumes of funds involved and collective decision making process which ensures strong internal control, they pose a low systemic risk. Further, informality, flexibility and simplicity are considered to be the strengths of the SHGs. Hence, as announced by RBI in its Annual Credit Policy in November 2003, it is considered desirable to leave the group dynamics of SHGs to themselves and they need neither be regulated nor formal structures imposed on them. Uncertainty in the minds of the banks and other stakeholders arising out of the absence of any legal status of the SHGs is largely addressed by endorsement of the operational aspects of various models of SHG-Bank linkage in the relevant guidelines issued by the RBI.

5.2 In spite of such involvement of the formal financial system in micro finance sector from early 1990s onwards, the concerns regarding 'outreach', however, continue to dominate. The significant degree of demand - supply gap has led to a prolific growth of a large number of prudentially unregulated institutions like societies, trusts, etc. which are involved in the promotion and nurturing of micro finance related activities under the SHGs-Bank linkage and the other emerging models. Their involvement covers vast spectrum of activities ranging from promotion of SHGs to partnering with banks for providing financial services. Empirically large number of these organizations work as facilitators and do not carry the micro finance assets and liabilities on their balance sheets. Most of them also do not handle cash, other than some larger NGOs, NBFCs, MACSs, some of which also function as "pass-

through" entities in "partnership" with banks. Examples of such "partnerships" are found in the relationship established by some banks with MFIs like SPANDANA⁶, Share-Micro Finance Limited⁷, etc. Thus, from a regulatory perspective, two distinct types of entities are active in the field of micro finance in India; one set of entities that function under the extant financial regulations and those which do not come under any prudential regulatory norms. Hence, the significant questions before the Group were: (a) whether to expand the regulatory perimeter to cover the entire microfinance sector under the existing regulatory framework; (b) whether to have a separate and exclusive regulatory framework for the microfinance sector; and (c) how to create an enabling environment with regulatory forbearance and relaxations, wherever necessary, so as to provide space for all players, both regulated or otherwise, to have operational synergies with the formal financial institutions. The issues were, therefore, debated keeping in view the following key considerations:

- a. Stage of development and role of the MFIs in India.
- b. Issues regarding raising of resources by the sector.
- c. The necessity for a favourable environment for growth of MFIs.
- d. Feasibility of ensuring compliance through oversight and supervision.
- e. The need for providing savings and remittance services involving MFIs.

At present, there are about 800 MFIs operating in India according to available information. Further, there are about 3000 organisations involved in promoting and facilitating the SHG-Bank Linkage Programme. All these organizations are formed under different legal forms, and provide a multiplicity of services to enable the poor to avail of financial services. Most of these institutions are not under any prudential regulation and hence often do not enjoy confidence of lenders, donors and other stakeholders. However, as these agencies perform a very important role, the need for creation of a favourable environment and appropriate regulatory framework for their orderly and sustainable growth is being increasingly articulated. The need for providing savings products like demand deposits and remittances services including money transfer is another important question. From the point of view of safety and reliability, the formal banking system is best suited for delivering these services. At the same time, considering the issues of effective outreach discussed in earlier

⁶ SPANDANA is a NGO operating in Guntur, Andhra Pradesh

⁷ SHARE Microfin Limited (Society for Helping and Awakening Rural poor through Education), Hyderabad, Andhra Pradesh.

chapters, there is a need to facilitate synergic relationships between banks and other out reach agencies to provide such services.

5.3. Against the above backdrop, the Group reviewed the available ground situation. It is observed that the MFIs are legally amorphous entities. In terms of regulation and supervision of MFIs, there are significant differences across the legal forms in relation to nature and extent of regulation and supervision. While 'for profit' MFIs, incorporated under the Companies Act, 1956 and registered as NBFCs under the RBI Act, 1934 fall within the purview of RBI regulations, 'not for profit' companies under section 25 of the Companies Act, 1956 are exempt from the regulatory requirements under the RBI Act subject to certain conditions. Hence, there is a view that there should be a single authority overseeing the MFIs across all the legal forms under a separate and exclusive legal framework. This, however, leads to the question that if a new legislation has to cover all microfinance activities undertaken by all entities of various institutional forms, there has to be clear definition of microfinance from the regulatory perspective. This however, is not amenable to an easy answer given the multidimensional aspects of the microfinance activities. Further, the utility of such new framework for the already regulated entities like banks and NBFCs who are the major players in the microfinance sector is very doubtful. Moreover, in respect of other entities engaged in microfinance activities under different legal forms the question that would arise is whether the new law will be in lieu of the existing laws or it will be an additional law which has to be complied with along with the existing ones. Hence, it becomes imperative to carefully assess this complex situation for finding pragmatic response to the question of an appropriate regulatory and supervisory framework. Preeminent in this consideration is the emergence of a safe yet sustainable microfinance sector which safeguards the interests of the poor as also the lenders, investors and all other stakeholders.

5.4. In considering the need or otherwise of a new regulatory and supervisory framework for MFIs, the Group also went through the recommendations of various earlier committees and groups that had considered the matter. It may be noted that the recommendations vary from suggestion for exempting the non-public deposit accepting MFIs from the point of view of prudential regulation to regulation by way of forming an SRO and finally to a full fledged exclusive regulatory framework for MFIs.

The gist of the recommendations of various committees/groups is given in **Annex 5.1**.

Response to Primary Concerns : Bridging the Gap with Safeguards

5.5 The arrangements under the Business Facilitators/ Correspondents, when fully rolled out, are expected to substantially fill the demand supply gap in composite financial services in rural areas and cover significant share of the microfinance portfolios including savings overtime. Thus, the potential savings are expected to be channelised into the formal banking system, thereby largely mitigating the risks of the clients, particularly the poor, which could have arisen from keeping deposits with unregulated or under-regulated entities.

5.6 The MFIs complying with the accepted code of ethics are expected to engage themselves in large numbers with banks under strict norms of due diligence and rating. The banks and development financial institutions are expected to assist the Business Correspondents including MFIs to build capacities, improve governance, standardize accounting practices, subject them to audit rigour, etc. which is likely to ensure orderly growth. The banks are expected to closely monitor the microfinance portfolio with adequate checks and controls as discussed in **Chapter 4**. Such MFI-Bank linkages, which will further mainstream the microfinance activities, will address the problems of poor accounting, absence of standard performance criteria, inadequacy of disclosures, and deficiencies in capacity in the sector. The Group feels that these problems rather than the absence of a separate and exclusive regulatory framework hampers an orderly growth of the MFIs. The MFI-Bank linkage is further strengthened with the recent opening of the ECB to NGOs engaged in microfinance activities under the Automatic Route which envisages an important role for the banks as the Authorized Dealers for determination of the eligibility and the "fit and proper" status of the NGOs for accessing foreign funds. Thus, while the concerns of wholesale suppliers of funds to MFIs like banks, financial institutions and international agencies are addressed through due diligence and rating relied upon by them, the interests of the retail providers of funds (i.e. small depositors) are protected by leveraging such MFIs only as "pass-through" intermediaries for channelising the funds to the well regulated entities like banks.

5.7 The Group feels that given the level of comfort of all stakeholders have in a well regulated entity like NBFC, the larger MFIs are expected to transform into NBFCs, possibly with support from MFDEF. Simultaneously, non-deposit taking MFIs may attempt self regulation approaches by forming State Level Associations with responsibilities for evolving code of ethics, uniform standards and practices of accounting and disclosures, empanelment and training of auditors, setting up of complaint redressal mechanism, customer education, etc. NABARD and other apex institutions like SIDBI may actively offer services of experts in the process on deputation or secondment basis. Simultaneously, a few amendments/clarifications to the existing Acts/Policies, which have been highlighted by the earlier committees/groups may expedite hassle-free expansion of the microfinance activities. Some of these are listed below:

a. In respect of section 25 companies

- i. Removal of ceiling for lending to SHGs and expansion of the purpose of loans to include microfinance for the purpose of exemption from regulation of NBFC by RBI;
- ii. Grant of Income Tax benefits as a matter of principle by including microfinance under the charitable objectives of Section 25 companies; and
- iii. Providing for SHGs to become members of the Section 25 companies.

b. In respect of NBFCs

- i. Relaxation in the norms for selling micro-insurance products;
- ii. Reduction of minimum level of FDI in NBFC engaged in microfinance activities; and
- iii. More liberal dispensation in the policy for branch licensing.

5.8 The Group is convinced that the above approach of further mainstreaming of the microfinance activities through greater MFI-Bank linkage under a framework of due diligence and rating of the MFIs described above will effectively address the concerns of risk management for the large sections of the microfinance clients on the one hand, and, on the other, enhance the degree of comfort desired by the lenders, investors, donors and other stakeholders. The Group also took into account the costs involved in providing for an all encompassing regulatory framework, its practicality and costs relating to effective supervision, and the follow up requirements

to address issues of deviant behaviour. The near infeasibility of effectively supervising the large number of institutions by a central authority has also been considered by the Group. Giving due weightage to the above facts, the Group has suggested in **Chapter 4** a set of broad guidelines that the banks need to follow to take care of the several concerns and protect the various stake holders' interest, even in the absence of a regulatory frame work. Some areas requiring regulatory forbearance and relaxations have also been discussed in **Chapter 3**.

5.9 Under the circumstances, a separate and exclusive regulatory frame work for the large number of highly diverse MFIs under different legal forms is not recommended, at least for the present. With greater uniformity emerging in the matters of accounting, governance, management capabilities, and financial stability of MFIs, a review on the need and modus operandi of regulation and supervision may be taken up at a later date.

Rate of Interest

5.10 The Group also briefly discussed another important regulatory issue relating to interest rates. The MFIs are now free to fix rates of interest according to their internal policies. There is a view that the cost to ultimate borrowers which may include service charges shall not be usurious. A few instances of collective protests against the high all-in cost paid by the borrowers of MFIs have surfaced. This problem may accentuate in future, particularly when the poor receiving micro finance scale up their credit requirement for the purpose of livelihood and micro enterprises.

5.11 Empirical data in respect of several micro finance projects being carried out in different parts of the world prove that timely availability and right quantity of credit and not the interest rate, is crucial to the success of microfinance programmes. Since the method of costing applied by microfinance institutions is fundamentally different from that followed by banks, the methodology for applying interest rates for them would be different from banks. As providing services at the doorstep of the customer has a cost, no undue intervention is required to set the interest rates charged to the ultimate borrower through the financial intermediation route. This may be left to the commercial judgment of the borrowing (MFI) and lending institutions (banks).

5.12 With the expansion of the micro finance market leading to increased business volumes, rise in the number of participants, use of low cost IT solutions to reduce transaction costs and progressive introduction of transparent pricing policy, it is hoped that the competitive forces shall determine fair price. Besides, easier availability of funds through bank funding and ECBs would help in reduction of rates charged by MFIs. Meanwhile, Industry Associations may, however, need to caution MFIs to see that cost of credit is not usurious as this has serious socio-economic implications.

Chapter 6

Conclusions

6.1 In spite of the commendable expansion of branch network and progressive policy initiatives, large number of rural population continue to remain outside the formal banking system for a variety of demand and supply side reasons and constraints. From the experiences gained from the success of the SHG-Bank linkage programme and other micro finance initiatives in India and abroad, it has been established that interfacing NGOs/CSOs and other socially conscious organizations/ persons between the banks and the ultimate customers would prove rewarding in the philosophy of "Financial Inclusion".

6.2 Based on the mandate given in the terms of reference, the Group studied the issues and prospects of enlarging the coverage of banking activities through widespread consultations with various stakeholders, review of literature and participation in seminars on the subject. The Group concluded that there is imperative need to work out efficient mechanisms involving external entities to cater to the under serviced areas and the rural poor. It was felt that such extended outreach would facilitate acquisition of a large number of customers, albeit small ones with substantial potential for large increase in business volumes and profit as banking with the poor is not poor rather profitable banking. Therefore, two models called the Business Facilitator Model and the Business Correspondent Model have been recommended as proactive response.

6.3 The arrangements suggested are expected to be substantially beneficial to both the demand and supply sides. The rural customers shall benefit by increased access to composite financial services in a relatively hassle free manner, inclusion of those in remote and resource scarce regions/ areas into formal system, significant reduction in borrower level transaction costs in view of doorstep/near doorstep availability of services, and better understanding of their needs by empathetic functionaries of outreach entities engaged by banks. The banks shall benefit by a substantially increased client base in rural areas large numbers of which are upwardly mobile. The increased outreach will also help banks to include a large number of excluded farmers and others in the unorganised sector into the banking fold. Better identification of clients and the possible diversification of activities shall

spread risks. These benefits can be achieved at much lower costs than that is feasible under the conventional systems and procedures. The arrangements will also provide an opportunity for a large number of socially proactive organisations and individuals to work in tandem with resource rich financial sector. This is likely to lead to a financial inclusion oriented growth model that aims at achieving socio-economic empowerment of the less advantaged sections. This will also provide an ideal platform for the microfinance institutions to grow at a faster pace.

6.4 The Group was also seized of the concerns arising out of risks associated with third party intermediation arrangements and analysed the various risk mitigation measures. Technology is envisaged to leapfrog the efforts to increase outreach on the one hand and substantially alleviate the risks on the other and, hence, is given a special focus in the report. Capacity building of the interfacing entities have also been dealt with.

6.5 The question of regulatory framework for MFIs was considered at length from different perspectives and viewpoints. The Group concluded that a separate and exclusive regulatory and supervisory framework for MFIs may not be required for the present as bulk of the microfinance portfolio, both under current dispensation as under the Models A and B proposed in the report , rest in the books of regulated entities like banks and NBFCs. Further, the measures suggested to forge strong NGO/MFI - Bank linkages under a strict framework of due diligence and rating would ensure safety and security for the customers on the one hand and reasonable level to comfort to lenders, donors and other stakeholders. The difficulties involved in bringing large numbers of amorphous entities under an expensive central regulatory framework, its impracticality and cost involved in effective supervision and follow-up also weighed in favour of this recommendation. In the meantime, the Group considered it desirable that the non-deposit taking MFIs may attempt self regulation by forming State level associations to evolve code of ethics, uniform standards of accounting practices and disclosures, empanel and train auditors, etc. with the assistance of NABARD and SIDBI.

6.6 Several support systems such as institution and use of funds from the Micro finance Development and Equity Fund, the National Micro Finance Information Bureau, the Rural Banking Technology Development Fund, and policy options and

regulatory relaxations in regard to permission to engage Business Correspondents, FDI norms, promotion and development of MFIs/CSOs, harnessing the capabilities of apex level organizations like NABARD, SIDBI, and associations of MFIs/NGOs have been recommended. Considering the special status of the North-East region, institution of a Social Venture Fund and a Risk Fund have been found relevant.

6.7 While propagating and promoting the models suggested, the Group also emphatically favours further expansion of the existing micro finance initiatives and institutions. The efforts of branch banking in rural areas including that of the cooperatives to increase the flow of credit to agriculture in particular and rural credit in general need to be continued with varied innovations and renewed vigour. Such an eclectic approach focusing on many models and multiple mechanisms is imperative given the degree and diversity of the Indian context.

Chapter 7

Summary of Major Recommendations

7.1 The major recommendations contained in **Chapters 3, 4 and 5** of this report are summarized below :

Extending Outreach - New Models & Arrangements

7.2 For providing comprehensive financial services encompassing savings, credit and remittance, insurance and pension products in the rural areas, linkages between banks and external entities may be established under two broad models as under :--

Model A : Business Facilitator Model⁸ wherein the banks may use a wide array of CSOs and others for supporting the banks by undertaking **non-financial services**: The Facilitators would provide support services for effective delivery of financial services, such as, (i) borrower identification (ii) collection, processing and submission of applications (iii) preliminary appraisal (iv) marketing of the financial products including savings (v) post sanction monitoring; (vi) promotion and nurturing SHGs/JLGs; and (vii) follow up for recovery. NGOs, Farmers Clubs, Functional Cooperatives, IT enabled rural outlets of corporates, Postal Agents, Insurance agents, well functioning Panchayats, Rural Multipurpose Kiosks/Village Knowledge Centres, Agri Clinics/ Business Centers financed by banks, Krishi Vigyan Kendras, KVIC/ KVIB units, etc. may function as the Business Facilitators. Trained individuals /retired bank employees with their familiarity with the local culture and language may also work as facilitators on contract basis. Such facilitators may be encouraged to increasingly use technological solutions and connectivity. **[3.3, 3.4,3.5, 3.6]**

Model B : Business Correspondent Model⁸ under which institutional agents/ other external entities support the banks for extending **financial services** : The Business Correspondents would function as "pass through" agencies to provide credit related services, like disbursement of small value credit and recovery of principal / collection of interest, and sale of micro insurance/mutual fund products/ pension products besides the functions described under Model A above. They may be authorised to accept/ deliver cash/ other payment instruments either at the door step of the customer or any other convenient locations subject to the cap as may be fixed

from time to time by the bank. Based on their performance over a period of time, they could be allowed to provide other important financial services, like (i) collection of small deposits and (ii) receipt and delivery of remittances upto a limit subject to compliance with statutory and regulatory requirements. Registered NBFCs with significant rural presence, NGO-MFIs set up under Societies / Trust Act / MACS with a charter to undertake financial functions, IT enabled rural outlets of corporates with appropriate contractual agreements with the principal, well running PACS and Post Offices may function as the Business Correspondents. **[3.3, 3.7, 3.8]**

Concerns & Safeguards

7.3 To address various concerns arising out of Business Facilitator & Business Correspondent relationships, banks have to rely on: (a) appropriate Board approved internal policy for identifying and accepting the Business Facilitators/ Correspondents; (b) risk management strategies; (c) rating of the correspondents; (d) due diligence to be carried out on them, (e) code of ethics and fair practices under which they shall operate, (f) transparent compensation policy, and (g) mechanism for on-going monitoring and review of the arrangement. **[3.10 to 3.31]**

Exposure Monitoring

7.4 As a concentration risk management measure banks may have appropriate exposure limits on business developed by the Correspondents and the portfolios developed through them may be segregated for easy identification in the bank's books/IT systems. **[3.23, 3.24]**

Compensation Package and Capacity Building

7.5 Banks shall provide reasonable fee/commission to the agencies involved in both the models based on the services provided. Performance based incentives/ penalties may be provided. The Business Facilitators/Correspondents may **not** be allowed to charge a service fee from the clients. The bank may provide operational manuals and capacity building support including training to such agents. **[3.31, 3.32]**

⁸ A schematic diagram of the models and another depicting the responses to the concerns and risks are enclosed as Appendices 1 and 2 to this chapter.

Customers Choice

7.6 The customers shall have the freedom to use branch banking facilities even though the Business Correspondents are available in their locality or they were initially sponsored by them Business Correspondents. **[3.34]**

Redressal Mechanism

7.7 The banks may formulate a scheme on the lines of "Banking Ombudsman" to provide an internal complaint redressal mechanism. **[3.35]**

Regulatory Clearance & Forbearance

7.8 RBI may issue general permission /clarificatory circular to the banks to pay commission/ fees to the Business Facilitators and Correspondents . It may accord specific permission to banks to conduct business through the Business Correspondents when approached in this regard. **[3.37]**

7.9 RBI may consider relaxing/ simplifying the documentation requirements under the KYC norms in respect of non face-to-face customers brought in by the correspondents subject to an overall annual transactions limit. **[3.37 (B)]**

7.10 RBI may issue guidelines to all banks incorporating the above features for taking effective steps to engage Business Facilitators/ Correspondents. Banks and the IBA may take up the issues that may arise during the transitional phase for issue further guidelines/ clarifications with RBI/ others concerned. **[3.38]**

7.11 Bank – Business Facilitator / Correspondent Relationship - Sharing of Information

The Business Facilitators/ Correspondents may have the contractual relationship only with one bank in a defined geographical area ; however , eligible entities can have relationship with different banks in different areas. A National Microfinance Information Bureau (NMIB) to gather information on Business Correspondents may be established by NABARD with the help of CIBIL and SIDBI. and NMIB may also facilitate sharing of such information including information regarding termination of agency arrangements due to negligence and fraud. NABARD may also capture and share the data/information on the MFIs and NGOs associated with the SHG-Bank linkage and MFI-Bank linkage programmes. **[3.39 ,3.40, 3.41]**

Sourcing International Funds for MFIs

7.12 RBI and Government may consider reduction in the threshold limit on FDI for NBFC-MFIs from US \$ 500,000 to US \$ 100,000. Alternately, such liberal dispensation may be considered for investments only by NRIs in this sector. **[4.6]**

Direct Finance from NABARD and Risk Mitigation

7.13 (a) The micro credit portfolio of the regulated MFIs may be made eligible for direct finance from NABARD and a line of credit may be extended by NABARD to provide liquidity assistance in view of the co-variant nature of credit risk of the MFIs.

(b) Insurance Regulatory and Development Authority (IRDA) in consultation with NABARD, SIDBI, MFI Associations, IBA and private/public sector insurance companies may examine in detail the scope of expanding the existing micro-insurance schemes and introduction of other innovative insurance products including group insurance to take care of the risks faced by the SHGs/micro entrepreneurs as well as the lending banks. **[4.7, 4.8]**

Capacity Building of MFIs

7.14 CAB and BIRD may develop suitable training modules for MFIs. They can also provide a platform for periodic interactions among MFIs, banks, policy makers and others concerned including the industry associations for cross learning and interface. **[4.10]**

Future Growth of SHG-Bank & MFI-Bank Linkage Models

7.15 The concerns and issues arising out of Bank-MFI "partnership" model may be studied by IBA and a model scheme be formulated for adoption by banks. Government, RBI, NABARD and banks may take effective steps to overcome the shortcomings in SHG-Bank linkage models, viz., limited number of NGOs in some areas, cost of promoting NGOs, low per capita outlay of credit, and overloading of SHGs with multiple agenda. Accounting standards for SHGs and NGOs may be developed, codified, and standardised by NABARD as a promotional initiative in consultation with ICAI. Banks may consider adopting a "consortium" approach for proper exchange of information while lending to MFIs to mitigate the risk of over financing. **[4.11, 4.12, 4.13, 4.14, 4.18]**

Micro Finance Development and Equity Fund (MFDEF):

Financial Support to MFIs & Microfinance Activities

7.16 Corpus of MFDEF may be built up on an ongoing basis by contributions by the banks which may be allowed as a tax-deductible business expense and from the Government out of the rural development funds to meet the capacity building expenditure of NGOs and MFIs. MFDEF fund may be utilized to : (a) provide bulk lending support to start-up MFIs, particularly in underdeveloped areas, (b) support the NGOs to help them to continuously monitor and nurture the SHGs, (c) help select NGOs and SHGs for development as resource centers for needy groups at state and national basis, (d) organize the Rural Entrepreneurship Development Programmes (REDPs) for SHGs based on detailed potential assessment of area specific economic activities and widely disseminate such information so that the SHGs may migrate to higher levels of micro enterprises, (e) obtain ratings of MFIs from accredited agencies and make them available in the public domain, (f) facilitate formation of SHG federations which may offer specialized services like rural housing loans and micro-insurance and tie-up with service providers for accounts and audit, capacity building, credit linkages with banks, etc. (g) provide Equity Capital or Quasi Equity to MFIs to expand their operations/ cover new areas and enhance the comfort level of the lenders and donors, and (h) cover operational deficits of the accredited rating agencies in the initial years. **[4.5, 4.11, 4.16, 4.17, 4.20, 4.22, 4.42, 4.47]**

Extending Outreach using ICT

7.17 To expand the outreach of banking facilities to underbanked areas in a convenient, reliable, secured and cost effective manner, the following steps may be taken :

(i) Banks may progressively use appropriate technology based on cost benefit analysis and study of usage, connectivity, and technology familiarity, language preferences and literacy of the clients. **[4.25]**

(ii) NABARD, in consultation with Ministry of Information and Technology, may draw up a time bound action plan to set up Rural Kiosks/ Village Knowledge Centers, partly funded from RIDF. These Kiosks can be leveraged for expanding Business Facilitators/ Correspondents relationships by the banks. **[4.27]**

(iii) The INFINET payment system backbone may be expanded to cover rural areas to enable banks to have an efficient, low cost and secured money transfer and settlement system using MFIs/other eligible outfits as conduits. **[4.29]**

(iv) IDRBT may be requested to examine, in consultation with NABARD, the feasibility of setting up a portal to enable e-marketing of products of SHGs/ micro entrepreneurs by making use of rural kiosks, Village Knowledge Centres, etc. Over time, the settlement can be web enabled by linking the portal with the payment gateways of banks financing the concerned SHGs/micro entrepreneurs. **[4.30]**

(v) A Rural Banking Technology Development Fund (RBTDF) may be set up by way of grants from Government of India, NABARD and international agencies for computerization and networking of rural branches, particularly of RRBs and cooperative banks. The cost on technology infrastructure in rural areas and contributions made to the proposed RBTDF may be included for computation of bank's achievement under priority sector advance, wherever applicable. **[4.31]**

(vi) IDRBT may take initiatives to design, test and disseminate low cost, secured technological solutions for financial sectors. Research on newer technologies can be outsourced and the technology can be patented and commercialised through interested IT companies. **[4.32]**

(vii) NABARD, IBA and IDRBT may publicise the use of innovative and low cost technologies available for rural banking. **[4.33]**

Promoting Micro Finance in the North East Region (NER)

7.18 A Social Venture Fund to support the growth of NGOs/MFIs and facilitate innovations in NER may be set up by the North East Council (NEC) in collaboration with NABARD. A Risk Fund could also be set up to induce financing agencies to extend micro finance to activities considered very risky. The NEC may coordinate for creating a network of NGOs working in the North East. **[4.36]**

Rating of Micro Finance Institutions

7.19 To ensure an effective system of rating of MFIs in a cost efficient manner, it is proposed that:

i. NABARD may develop a suitable rating model in consultation with SIDBI, CRISIL, MCRIL and MFI associations. **[4.45]**

ii. Standard accounting practices and norms of governance are established by the MFI associations with support from NABARD and SIDBI. **[4.40]**

iii. NABARD, SIDBI, and major banks may consider promoting independent rating agencies by way of equity contributions to increase the number of accredited rating agencies. **[4.42]**

iv. NABARD may subsidise the cost of rating, fully if found necessary, to the MFIs /NGOs to encourage them to get themselves rated and such rating information be made available to banks at their Head Office / Regional Offices. **[4.47]**

v. Accreditation of rating agencies may be undertaken by the proposed NMIB or NABARD. **[4.41]**

Regulatory issues and concerns for MFIs/other outreach entities

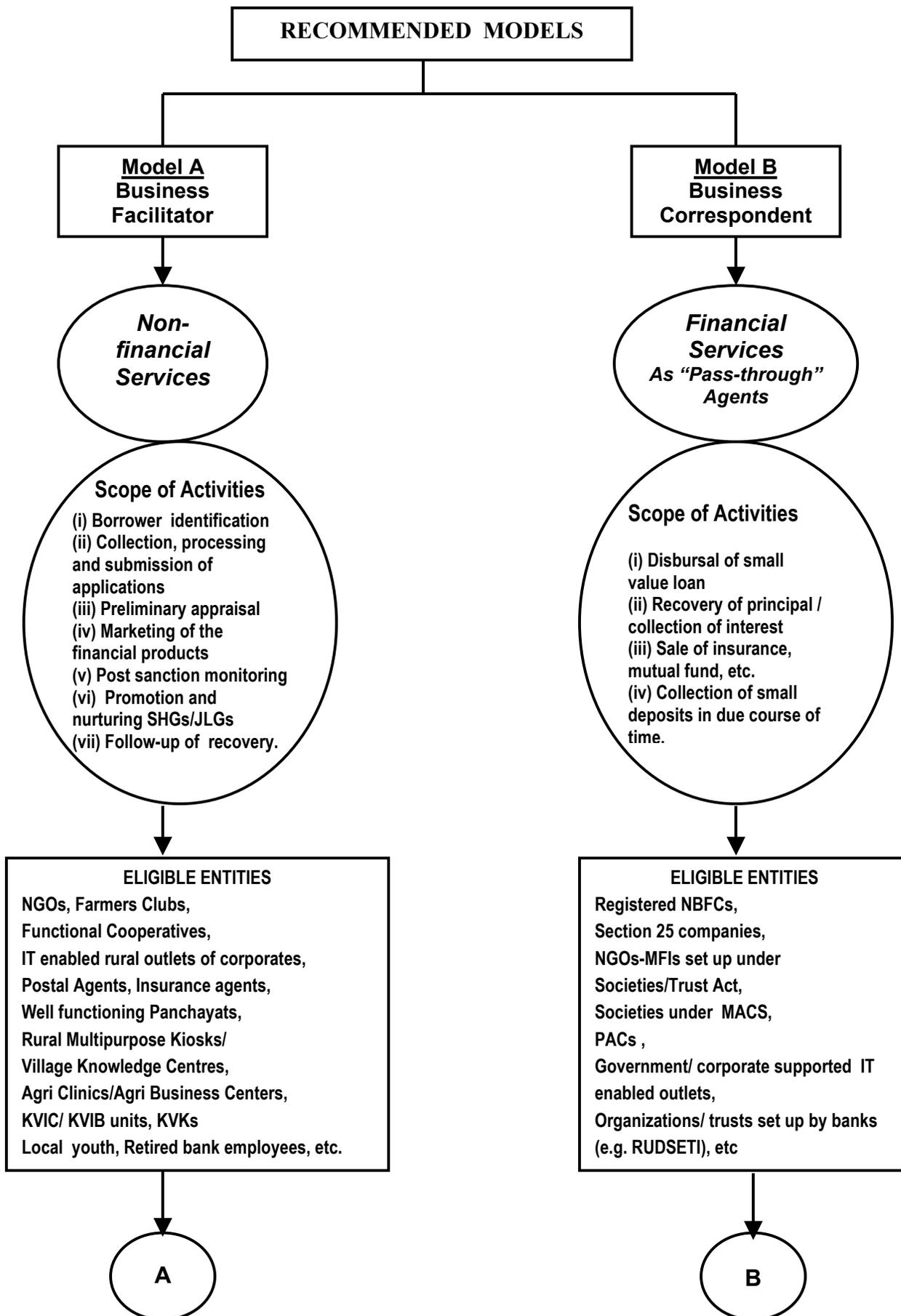
7.20 A separate and exclusive regulatory and supervisory framework for MFIs may not be required for the present in view of the following factors: (a) major players undertaking micro finance activities are well regulated entities like banks and NBFCs, (b) the Models A and B suggested in the report shall forge NGO / MFI - Bank linkages leveraging the strengths of the NGO-MFIs while most part of the micro finance portfolios shall rest in the books of the regulatory entities (i.e. banks), (c) NGO-MFIs shall be selected for bank linkage under a strict framework of due diligence and rating thus ensuring safety and security of the customers' funds on the one hand and reasonable level of comfort to lenders, donors and other stakeholders on the other, and (d) there would be a lot of difficulties in terms of cost and outreach in bringing large numbers of amorphous entities under a central regulatory framework. The question of a comprehensive regulatory framework may therefore be taken up for review at a later date. **[5.11]**

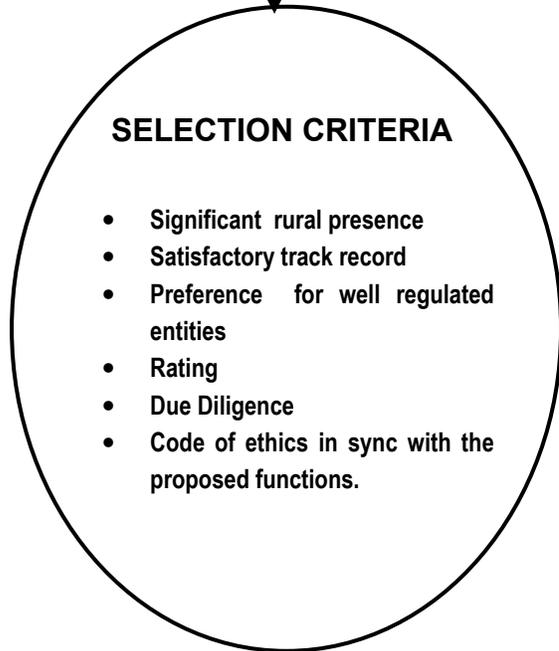
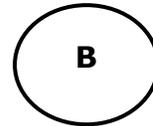
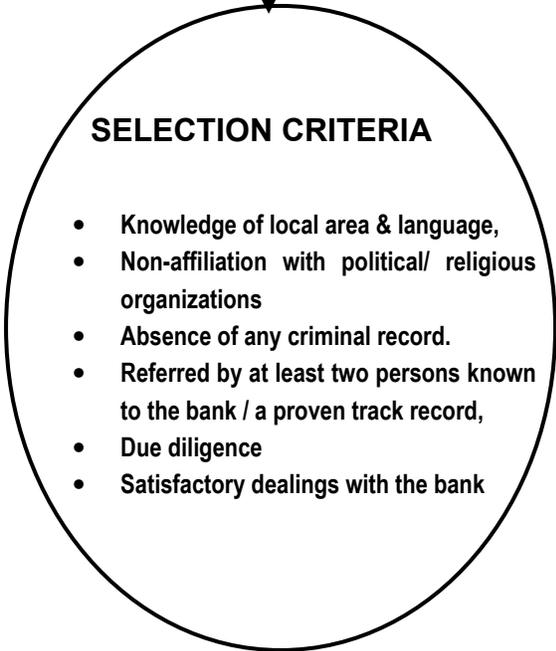
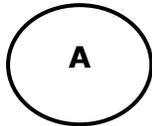
7.21 Non-deposit taking MFIs with assistance from NABARD and SIDBI may attempt self regulation by forming State level associations to evolve code of ethics, uniform standards in accounting practices and disclosures, empanel and train auditors, set up complaint redressal mechanism, educate the customers, etc. A few amendments/clarifications to the existing Acts/policies suggested in **Chapter 5** may be considered for hassle free development of the microfinance activities involving various types of MFIs, viz. section 25 companies and NBFCs. **[5.9]**

Rate of Interest

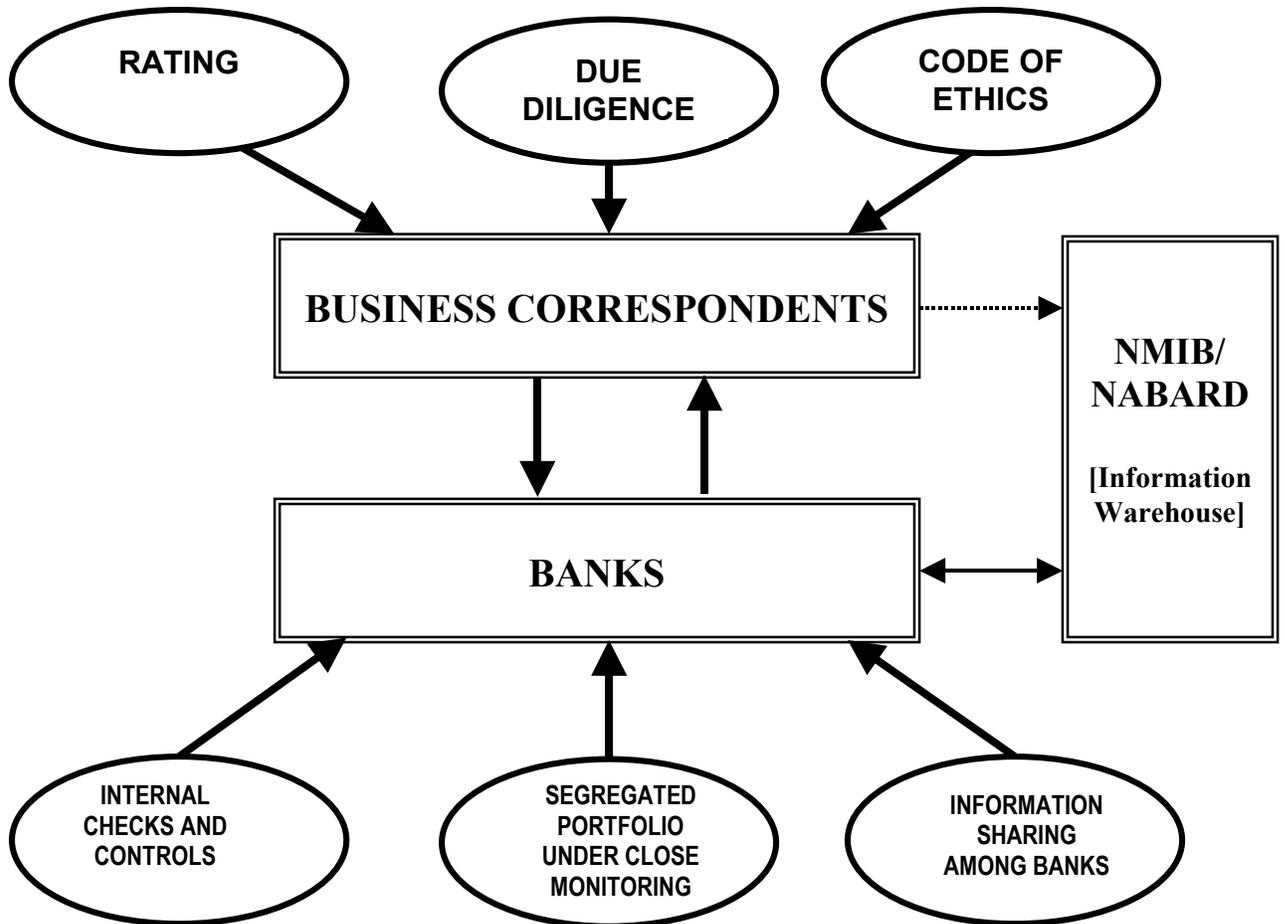
7.22 Considering the high transaction costs and the emphasis on timely availability of credit, it may not be appropriate to fix any ceiling on interest rates and service fees charged by MFIs, particularly as it is expected that the competitive forces will determine the fair price. In the meantime, there is a need for caution to see that the cost of credit is not usurious. **[5.14]**

Schematic Diagram of the Recommended Models





**Schematic Diagram of Responses to Risks & Concerns
in the Recommended Model**



**Persons and Orgainsations consulted/
from whom written responses received**

Commercial Banks

- 1 ABN Amro Bank
 - 2 Andhra Bank
 - 3 Bank of Baroda
 - 4 Bank of Rajasthan Ltd
 - 5 Canara Bank
 - 6 Central Bank of India
 - 7 Corporation Bank
 - 8 Dena Bank
 - 9 HDFC Bank
 - 10 ICICI Bank
 - 11 Indian Bank
 - 12 ING Vysya Bank
 - 13 Punjab & Sind Bank
 - 14 State Bank of India
 - 15 State Bank of Hyderabad
 - 16 State Bank of Patiala
 - 17 State Bank of Saurashtra
 - 18 Syndicate Bank
 - 19 UCO Bank
 - 20 Vijaya Bank
- Regional Rural Banks**
- 22 Chandrapur Gadcholi GB
 - 23 Malaprabaha GB
 - 24 Marathwada GB
 - 25 North Malabar GB
 - 26 Pandyan GB
 - 27 Rushikulya GB
 - 28 Sree Ananatha GB
- Local Area Bank**
- 29 Krishna Bhima Samruddhi Local Area Bank Ltd.

MFIs and NGOs

- 30 AP MAS
- 31 BASIX
- 32 Sa-Dhan
- 33 Share MicroFin Ltd
- 34 Spandana
- 35 Swayam Krishi Sangam
- 36 DIVYAYAN KVK, R K Mission
- 37 PRADAN
- 38 SEWA Shakari Bank
- 39 Kalanga Bazar Education Trust
- 40 MYRADA
- 41 SANGAMITRA
- 42 SKDRDP
- 43 Initiatives for Development Foundation
- 44 OUTREACH
- 45 Grameena Koota
- 46 Friends of Women World Bank

Financial Institutions

- 47 NABARD
- 48 SIDBI
- 49 NEDFi

Corporates

- 50 Hindustan Lever (Microfinance Division)
- 51 ITC (International Business Division)

Others

- 52 Indian Institute of Bank Management
- 53 Banco Central do Brasil (Central Bank of Brazil)
- 54 Lok Capital

MFI-Bank Partnership Model⁹

Under the Partnership model, which has been pioneered by a large new generation private sector bank, the MFI sources loans directly in the books of the bank but continues to monitor and recover loans thus disbursed. This releases the MFIs from their capital constraints and allows them to achieve rapid increase in outreach. The NGO/MFI continues to perform the role of social intermediary, a role for which it is more than adequately equipped, while the financial intermediation and therefore the credit risk is left to the bank. This is a model that makes effective use of the strengths of both the partners.

The model has been conceptualized and executed with the following key characteristics:

(i) *Loan contracts directly between the bank and the borrowers*

The loans are contracted directly between the bank and the borrowers and hence it does not reflect on the balance sheet of the MFI. The MFI continues to service the loans until maturity. The bank relies on the MFI's field operations for collection and supervision. The financial structure attempts to separate the risk of the MFI from the risk of the underlying portfolio. Since the bank directly lends to borrowers, it has recourse to them. In this case, even if a particular MFI is closed down for any reason, the bank can appoint another agency to recover the dues from the borrowers. Moreover, since the loans are not reflected on the balance sheet of the MFI, its own requirement for regulatory capital ceases to exist. The shift to asset based lending from organization based lending has crucial implications for rating, pricing and consequently marketability.

(ii) *Alignment of incentives with a first loss guarantee structure (FLDG)*

The financial structure requires the MFI to provide a guarantee (a first loss default guarantee) through which the bank shares the risk of the portfolio with the MFI upto a certain limit. FLDG makes the provider of the guarantee liable to bear losses upto

⁹ Based on the working paper titled "Financing Micro Finance – The ICICI Bank Partnership Model" by Bindu Ananth – February 2005 and article "The ICICI Bank, India" by Tara Nair, M.S. Sriram and Viswapath Prasad published in the Book "Small Customers and Big Market – Commercial Banks in Microfinance

a certain specified limit, say for the first 10 or 20 percent of loss on the portfolio. The FLDG forces the guarantor to prevent any losses at all as it is affected adversely right from the start. The quantum and pricing of the FLDG depend on the operating capability and maturity of the MFI. The MFI collects a service charge from the borrowers to cover its transactions costs and margins. The lower the defaults, the better the earnings of the MFI as it will not incur any penal charges vis-à-vis the guarantee it provides. The bank receives a fixed amount as interest on its loan.

(iii) Transfer of implicit capital from the bank to the MFI through an overdraft facility

To resolve the risk capital issue for the MFI, the bank have evolved a structure that combines the provision of both debt as well as mezzanine finance. Along with advancing of credit to meet the demand of the clients, the bank often provides an overdraft (OD) facility to the MFI. The OD facility is equivalent to the amount which the MFI is liable to provide as the FLDG. The OD represents funds committed but not utilized. The OD is drawn only in the event of default. On default, the MFI is liable to pay a penal rate of interest on the amount drawn down from the OD facility.

(iv) Partnership model and securitisation

The microfinance assets originated under this partnership model facilitate participation of a wider investor base through the process of securitisation. This may involve sale of portfolio by the originating bank to another bank in the initial phases. When the microfinance pools become larger in size, issuance of securities that are backed by microfinance assets become conceivable. The partnership model financing that separates risk of the MFI from the risk of microfinance loans is a precursor for securitising microfinance loans. The process of securitisation releases capital for the originator of fresh assets at a frequency that is more than what would be possible if MFIs held assets on their own balance sheet to maturity. The MFI also experiences rating arbitrage and the improved rating results in lower costs of financing. The lending rate has fallen from an average of 12% to 8.5% in a matter of two years with the transition in financing structure. The process catalyses development of a secondary market for microfinance where some entities specialize as originators and others emerge as buyers/investors.

Rating of Micro Finance Institutions

Rating of Micro Finance Institutions has been an on-going process worldwide, and a large amount of research has been undertaken in this area. Basically, the rating tools attempt to assess whether the MFI is operating on sound lines and on a sustainable basis. Most often, rating is a pre-requisite for extension of financial arrangements/partnerships. Further, the rating tool can also give a comparative position of the MFI in relation to its peers. The more popular of the rating methodologies used are ACCION's CAMEL, WOCCU's PEARLS, PlaNet Rating's GIRAFE and the rating methodologies of Micro Rate and M-CRIL. Overall these assessment tools use more than 170 indicators to evaluate MFIs.

2. Broadly, all the agencies look at the issues of: (i) Transparency, both operational and financial, (ii) Sound Operating Methods, (iii) Scale of Operations, and (iv) Sustainability. In all these elements, both qualitative and quantitative variables are examined.

3. *Given below are key parameters that are examined while arriving at the rating of an MFI.*

(A) Non-Financial Parameters

Governance

(a) The main aspects examined here are: (i) Whether the MFI has a clearly defined Mission Statement and Charter, which are known to both the employees and the clientele, (ii) Whether the Board membership is diversified and independent directors are present on the board and actually participate in meetings, and (iii) Whether the Board takes the major policy decisions.

Management

(b) The qualification and competence of the top management of the MFI and their experience in the sector is assessed. The presence of a second line of leadership which gives greater strength to the MFI.

HR Policies

MFI operations are heavily dependent on the performance of the frontline staff. Therefore, the critical areas to study would be whether the MFI has a well laid out recruitment and training system, tolerable levels of staff attrition and suitable delegation of operational powers.

Systems and Procedures

(c) As the scale of operations of a MFI grows, the systems and procedures play a critical role. The MFI should have well laid down policies for processing and authorisation.

Organisational Structure

(d) The key strength of a MFI is its ability to reach its clientele. In this context, the physical organisational structure of the MFI and its level and regularity of contact with the clientele are important parameters.

Information System

(e) The key to MFI operations is the ability to track its portfolio on a near real time basis. The information system should be able to provide portfolio performance to the corporate office as quickly as possible from the time of occurrence of a default.

Product Range

(f) A good MFI would need to have a range of products in tune with the requirements of the client group.

Geographical Spread

(g) Better geographical spread would give the MFI the capacity to spread its risk over a larger expanse and give it greater scope for scalability in its level of operations.

Client Assessment

(h) A MFI can also be rated on the basis of how its client group assesses the performance of the MFI. Independent studies, if done, as well as direct independent interaction with clients and dropouts can be referenced.

Growth Problems

(i) The future plans of the MFI should be clear and well planned, which is what the lending agency would be closely looking at.

(B) Financial Parameters

Under the financial parameters, the key parameters that are examined are:

Capital Adequacy

(a) Capital adequacy is a measure of an institution's financial strength and the extent to which an institution's capital charge allows it to absorb potential losses on its asset portfolio. As with other formal financial institutions, a capital adequacy of 8% or more is suggested. However, this would depend on the comfort level of the lending institution with the MFI. An 8% capital adequacy would translate to a 12.5 times leverage. As raising of equity continues to be a challenge for MFIs, Donor Funds and other Quasi Equity are also reckoned towards equity apart for the accumulated reserves. While making future expansion plans, the MFI would also be required to indicate how it plans to raise equity to meet future requirements.

Asset Quality

(b) Under this parameter, the key issue that is examined is the extent of portfolio at risk (PAR). PAR is defined as the total balance of loans that are past due. Past due is usually defined as installments that are due for more than 30 days. In such cases, the entire loan outstanding against such accounts is classified as portfolio at risk. Ideally, the PAR of any MFI should be in the range of 0-3% and in any case should not exceed 10%. All rescheduled loans are reckoned as part of PAR, even if the installments after reschedulement have not fallen due. Also under Asset quality, the provisioning and write-off policy of the MFI is examined. An MFI is considered to be good if it is able to make full provisioning for the PAR and has a well laid out write-off policy.

Earnings

(c) All MFIs have long-term need to cover their costs including overheads. Two indicators that are used in this regard are operating self-sufficiency (OSS) and financial self-sufficiency (FSS). OSS indicates that the MFI is fully covering its costs. FSS on the other hand assesses whether the MFI is covering its cost and earning surpluses even after factoring in the donor grants and implicit subsidies that the MFI is obtaining.

Liquidity

(d) The liquidity dimension of the MFI is examined from the point of view of whether the MFI is able to manage its finances in a manner that enable it to meet all external liabilities as and when they fall due.

Asset-Liability Matching

(e) This parameter examines the maturity profile of the assets of the MFI and the Liabilities to establish that there are no mismatches likely in the future when the liabilities fall due for payment.

Transparency and Disclosure

(f) The presentation of statement of accounts of the MFI are also examined from the point of view of transparency and full disclosure, including making available all requisite details to both financiers and the clients.

Indicative Parameters for Due Diligence

The due diligence on entities to be engaged as the Business Facilitator/ Correspondent shall factor the key risks and other risks identified of different capacities of entities as discussed in **Chapter 3**. Some of the indicative parameters for due diligence of MFIs/ other entities while considering agency /funding relationship with them are given below.

(A) Due diligence in case of NGO/ MFI

- (a) *Charter and Registration* – The foremost would be to examine whether the charter and objectives of the MFI / NGO permit it to undertake the kind of activities proposed, especially if it is some form of financial intermediation.
- (b) *Presence in the area* – MFI / NGOs with adequate presence in the area for a reasonable time period would be preferable, as they would have developed better networking and understanding of local conditions.
- (c) *Management and Governance Structure* - Many NGO/ MFIs are almost solely driven by the founders. It is essential to examine the composition of the governing body of the entity to assess if it can function independent of the promoter and if there is a second tier of management.
- (d) *Manpower Quality and Retention Rates* – The quality of manpower from the perspective of undertaking the new task needs to be assessed. If not available in sufficient number, plans of the MFI / NGO to strengthen their manpower through recruitment and training are to be considered.
- (e) *Social vs. Profit Orientation* – Often MFI / NGOs are social service oriented, which may hamper undertaking a task like financial intermediation. This needs to be carefully assessed as the two are vastly different competencies.
- (f) *Accounting Systems* – The accounting systems and methods need careful study, especially in case the MFI / NGO is being considered for acting as a financial intermediary.
- (g) *Secular and Social Orientation* – The MFI / NGOs should preferably be non-discriminatory on caste, gender, political affiliation and religious lines. While its work could focus of specific groups or communities, it should not have any negative discrimination. The commitment of the entity for catering to the

unserved, poor, and disadvantaged sections including women, etc. may be seen.

(h) *Assessment of Donors Partners and Peers* – Assessment of the MFI / NGO by the donors, partners and peers would be a crucial input in assessing the capabilities of the MFI / NGO. This can be obtained from independent discussions with the donors, partners and peers and the government agencies connected with such programmes.

(i) *Financial Reporting* – The financial reporting of the MFI / NGO will indicate both the transparency and compliance to the laws of the land. It is to be seen whether there is consistency in financial reporting to the reporting authority, government, and donors etc.

(B) Due diligence in case of a SHG Federation like Societies under MACS

In the case of the federated structure, the strength of the federation would depend on the health of the constituent SHGs, as the financial assets would be with the members of SHGs. Hence, the due diligence parameters would be a little different from a typical MFI. Some parameters for rating a Federation could be as follows:

(a) Governance Related

(i) The federation should have a system of rating its constituent SHGs at periodic intervals, preferably six monthly. At least 75% of the SHGs should be rated on all the defined parameters. (ii) The federation should be a registered body and have capacity to enter into legal obligations. (iii) The federation should have a defined area of operation and have only primary SHGs as members. (iv) The federation should have an elected board which should meet at regular intervals. (v) The accounts of the federation should have been audited and placed before the General Body within 6 months of the closing of the accounting period. (vi) The federation should have filed all the statutory returns before the appropriate authority.

(b) Finance Related

(i) The federation should be in operating profit from the thrift and credit operations. (ii) The thrift collections at the SHG level should be at least 90% of the determined amount. (iii) The share capital mobilization should not be in arrears. (iv) The federation should demonstrate a repayment performance of 90% or more on a continuous basis. (v) At least 95% of the Loan Assets should be in performing

category. (vi) The federation should have made adequate loan loss provisions.
(vii) The federation should have defined exposure norms for individuals and groups.

(C) Due Diligence in case of other entities

In case of entities other than MFIs and NGOs, a due diligence may have to be more rigorous. The important aspects which need to be seen are :

(i) details of incorporation and promoters, (ii) details of management staff including qualifications, experience, other business activities, financial status, etc. (iii) particulars of employee level expertise. (iv) type of infrastructure available, (v) financials position, (vi) present business relationships and their status and (vii) adherence to the various local rules and regulations.

Extension of Outreach of Banking Channels through ICT Solutions

1. Information Dissemination Technologies

(i) *Information Kiosks*: Kiosks are best suited for dissemination of information regarding various financial products, training to farmers, weather information, market information, etc. Taking the number of illiterates in rural area the kiosks designed in local languages with voice facility would greatly help in increasing the outreach to poorer section of the society. It would act as supply driven credit flow to rural sector. As these kiosks require continuous updation of data, the job can be assigned to teachers/unemployed youth available in that area with suitable training and a small remuneration.

(ii) *Call Centers*: Call Centers can help information dissemination and cross selling of products to all kinds of customers. They can help in assisting customers even from rural areas to get information on availability of credit and terms to comply. Banks can set up such facilities (toll free) in every State. The expenditure may be shared among participating banks in the State.

(iii) *Toll free IVR System in local language*: Banks may provide toll free Interactive Voice Response System (IVRS) in local language to customers as a part of information dissemination strategy.

2. Business Processing Technologies

(i) *Simputer*: Simputer is one of the solutions that effectively meets the need of information access & communications and business computing requirements. It is a specialised Personal Access Device (PAD), versatile beyond the limitations currently seen in hand phones, Personal Digital Assistants (PDAs), Smart Phones and Laptops. Simputer is designed to provide support for data and voice communications on Internet protocols, enterprise applications access, secure transactions and personalized information delivery. As a Smart Card application deployment platform, Simputer is a secure, shareable, inexpensive and complete application access device. Simputer is, in short, the very efficient converged mobile computing device. It is a most convenient instrument to be used for remote on-line banking transactions.

As a few Indian companies are now in a position to manufacture these in a cost efficient manner, some of the organisations in India are planning to use this technology to transact banking business from a unbanked remote areas.

(ii) Mobile Phone Banking : Mobile banking assists customers in balance inquiries, transfer requests, bill payments, buy/sell trading orders, and other service enquiries. Mobile banking allows users the ability to access financial information, manage financial transactions, and make choices related to purchases via wireless or Internet enabled devices. Integrated systems that combine hand-held computers, smart cards, and sophisticated back-end infrastructure with mobile device would help in putting in place automated credit decisions and transactions system. These systems can extend the outreach by enabling remote transactions, improve customer service by facilitating on-demand credit approvals, and reduce transaction cost by freeing up branch staff to handle less routine transactions. Some of the banks have already started using the technology to extend banking facilities, including in remote areas in a limited way.

(iii) Automated Teller Machines(ATMs) : ATMs can be efficient transaction handlers, freeing up scarce staff and possibly be vehicles for a broader range of financial products. This is one of the successful technologies tried across the globe for transacting banking business. In order to use ATMs in a rural environment, it may be necessary to make certain adaptations to the technology. Where literacy is an issue, supplementing written text with verbal instructions in the local language may help. To work in rural area, in addition to use of a magnetic stripe card and PIN to identify account holders, other approaches like smart cards with fingerprint validation to allow people with low levels of education to avail of the facility may be considered. To enable installation of ATMs, which may act as Information Kiosks also banks need to have a central database system in place.

(iv) Smart Cards : The smart card can reduce communication costs since balances can be reflected immediately on the card and daily transactions can be batched to the central processing site. This is in contrast to the real-time connection required for verification, which is more widely seen in the case of usual magnetic-stripe card process. As applications multiply, smart cards can be used as a common mechanism to identify the cardholder and process transactions. Smart Cards can also be used for storing information in respect of Kisan Credit Card (KCC). Through

the Smart Card the farmers will be able to purchase farm inputs and equipments, in addition to availing loans, depending upon the limits sanctioned on the card. Chip-based Smart Cards could be used to store information pertaining to land records, limit sanctioned, amount withdrawn against bank account, etc. Moreover, they will be safe alternatives as they carry personal information like picture, signature or thumb print, previous credit data etc. In some instances, a few MFIs have found them a useful tool to replace paper transactions and improve the speed and accuracy of services. Since Smart Cards contain all essential client financial information, transactions can be immediately reflected. There is no need for online access to a network for each transaction as it involves huge cost. The batch mode updation is ideal. Recently NABARD has launched an experiment through five branches of two RRBs each in Andhra Pradesh & Karnataka by introducing smart cards for active clients and SHGs. This project enables SHG women in rural areas to access the kiosks through Smart Card and biometric based password system. Comprehensive SHG books are maintained in the Kiosk with member wise details. The groups are able to generate individual accounts balance sheet and other data about the group. Automation of book keeping in SHGs is expected to reduce paper work, save time and, thus, improve the efficiency of the field worker. This is also expected to reduce the scope of manipulation, reduce unintended leakages and also maintain up to date books at SHG level. The results of these experiments should be widely disseminated for adoption by others.

(v) Personal Digital Assistants (PDAs): PDAs are small, handheld digital computers that can run customer data and perform financial calculations. Using PDAs, field officers of the banks or agents can work with little or no paper at all, they can consult an electronic list of borrowers in arrears to plan collection visits, review clients ready to apply for their next loans, and refer to historical client information, while working on the field. They also can fill out loan applications forms and calculate the indicators for loan review and approval. All client data and visit records are stored electronically and are immediately available. In short, PDAs create standardized credit methodology and operating policies, improves efficiency, and increase data accuracy and access; thus, complementing the MIS of banks.

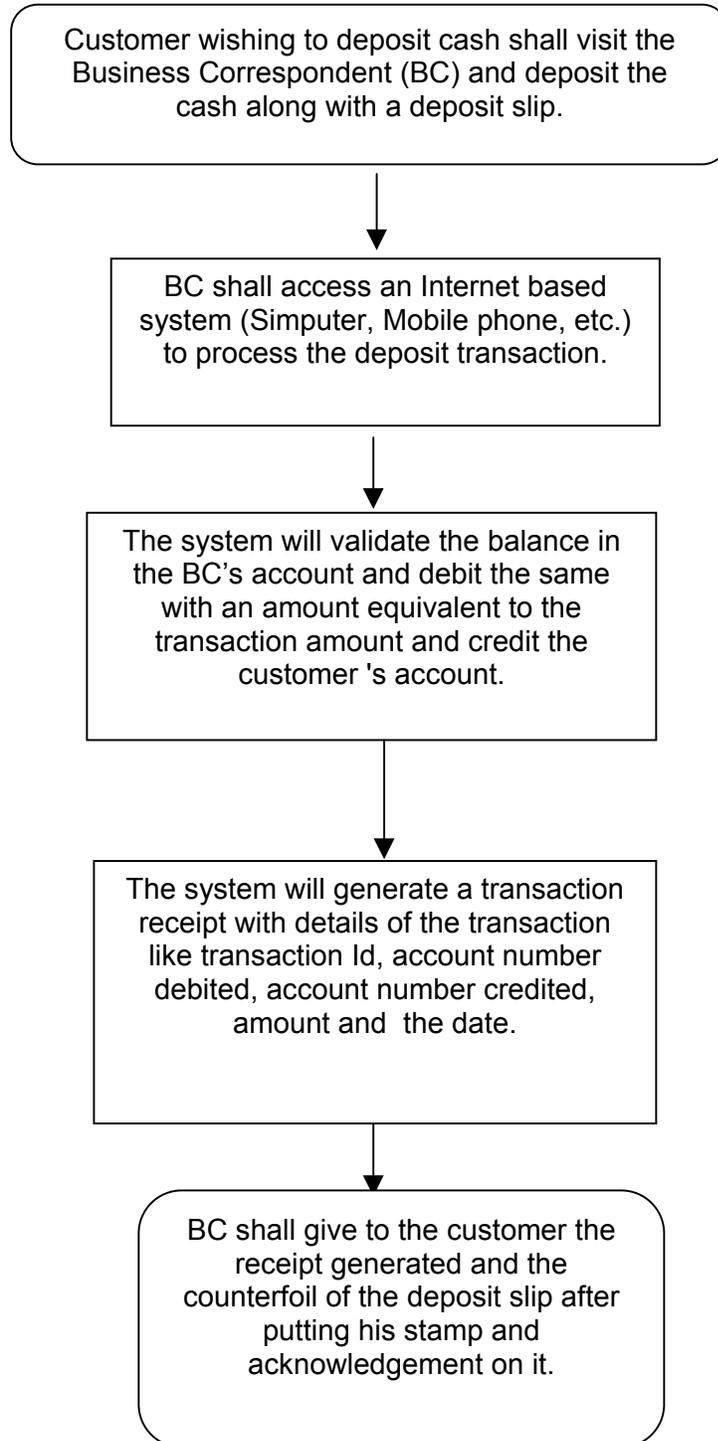
3. Computer “Munshies”:

An NGO, which has promoted more number of SHGs, felt that sustaining the groups would be a major problem if a proper accounting system and a stronger MIS were not put in place urgently. They, therefore, came up with the idea of "Computer Munshies". The idea involves identification of skilled rural youth for the accounting work by providing training as Computer Munshies (CM). The trained individuals would be equipped with a computer and software to serve 100 to 300 SHGs. The SHG level meeting transaction statement will be send to the CM after every meeting, which will be keyed in by the CM using the software which would generate outputs like trial balance, member savings and loan balances. The SHG promoter and the banker could also access data about SHGs from the CM on payment of a fee. The software also generates number of useful reports including 19 different ratio analysis. The data could be aggregated at the cluster or block level to make assessment of the functioning of the groups in a specific geo-span. It also facilitates financial analysis, drawing a trial balance, balance sheet, portfolio analysis, and member level impact - by capturing the base line data etc. The outputs generated could be useful to all related stakeholders including bankers, social intermediaries and the SHG themselves. Wider acceptance of such technology solutions upon their successful implementation may be encouraged by banks.

4. Illustrative flowcharts on possible use of technologies under the Business Correspondent model for safety and reliability of transactions that are captured either on a real time basis or in a batch-processing mode are given in the following pages.

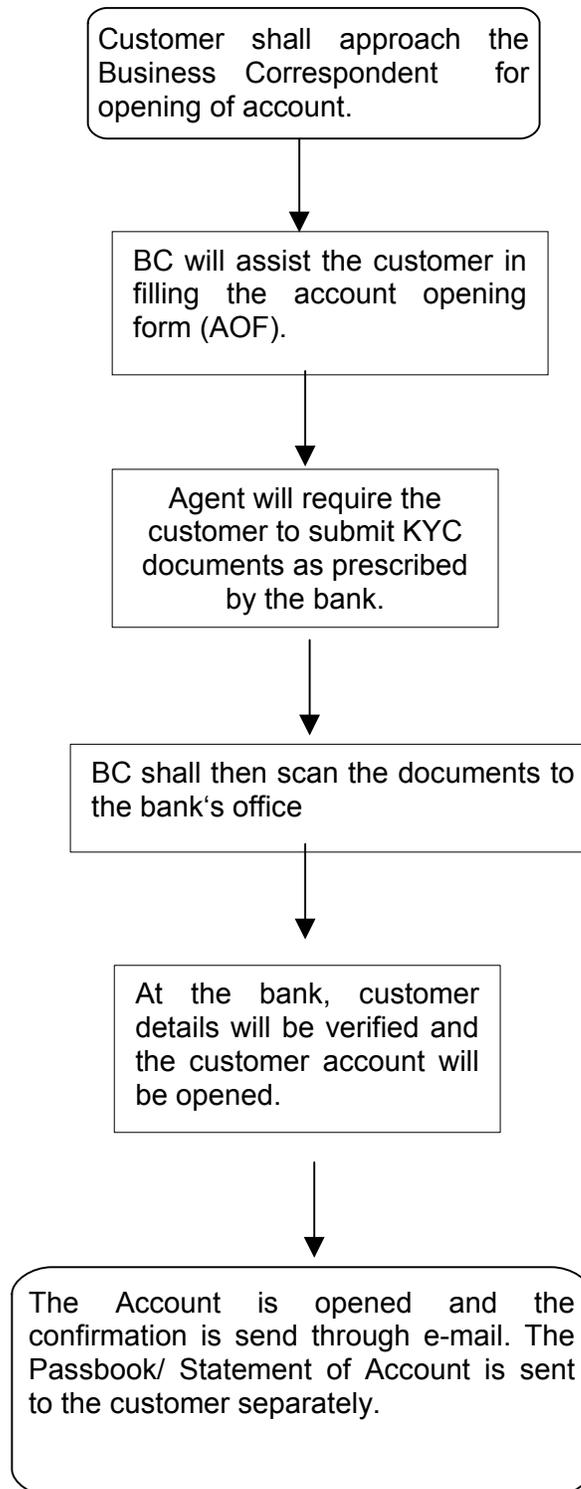
Flowchart: 1

Cash Deposits (Receipts/Repayments) through On-line Transactions



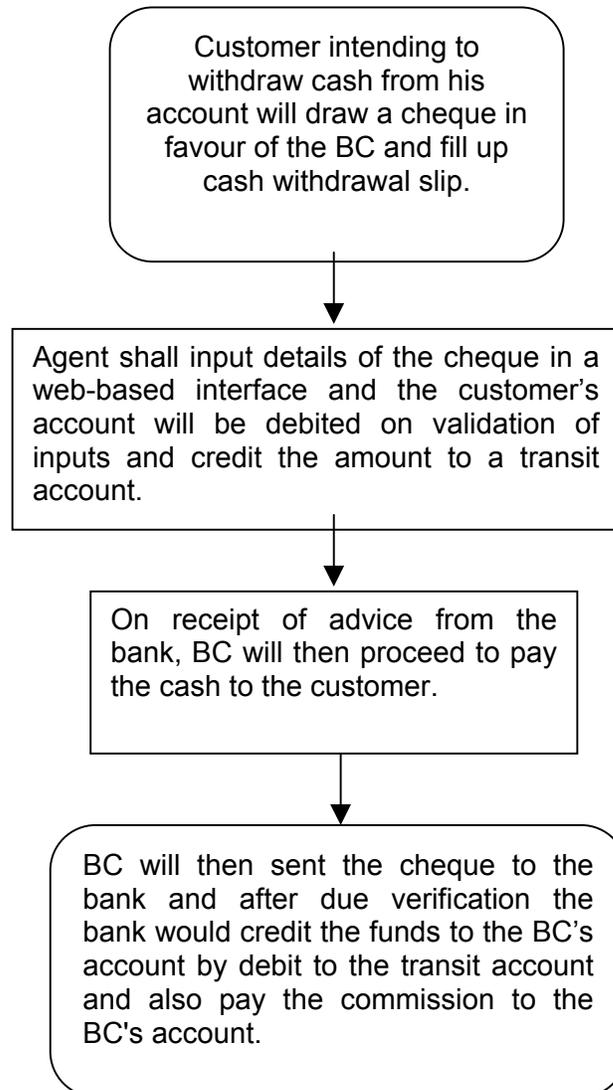
Flowchart: 2

Account Opening Process



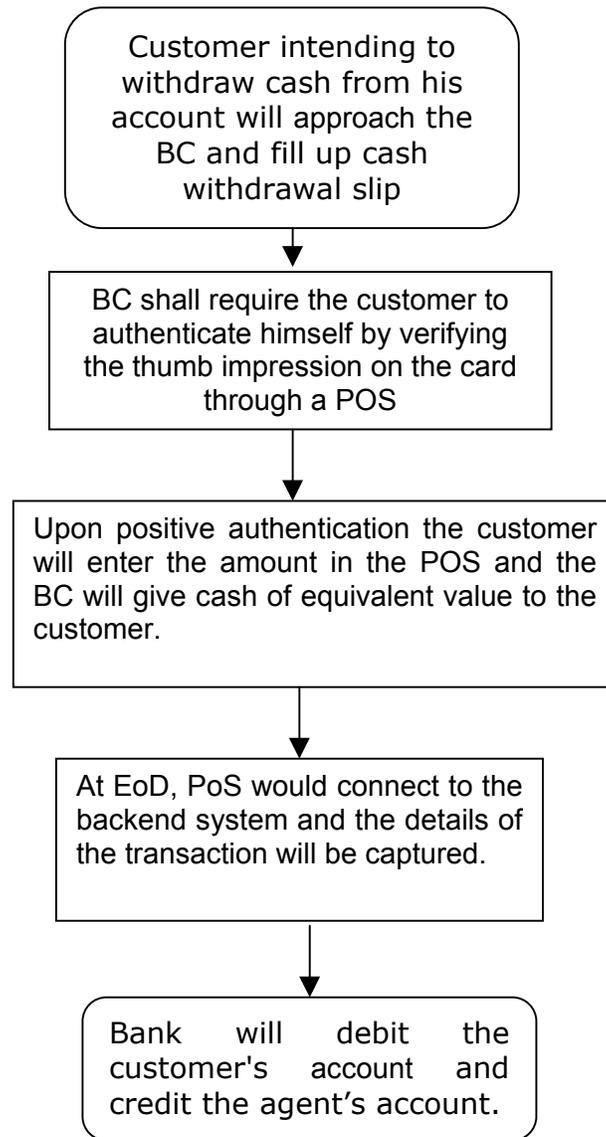
Flowchart : 3

Cash Withdrawal (Cheque based)



Flowchart: 4

Cash Withdrawal (Involving Smart Card)



EoD = End of the Day

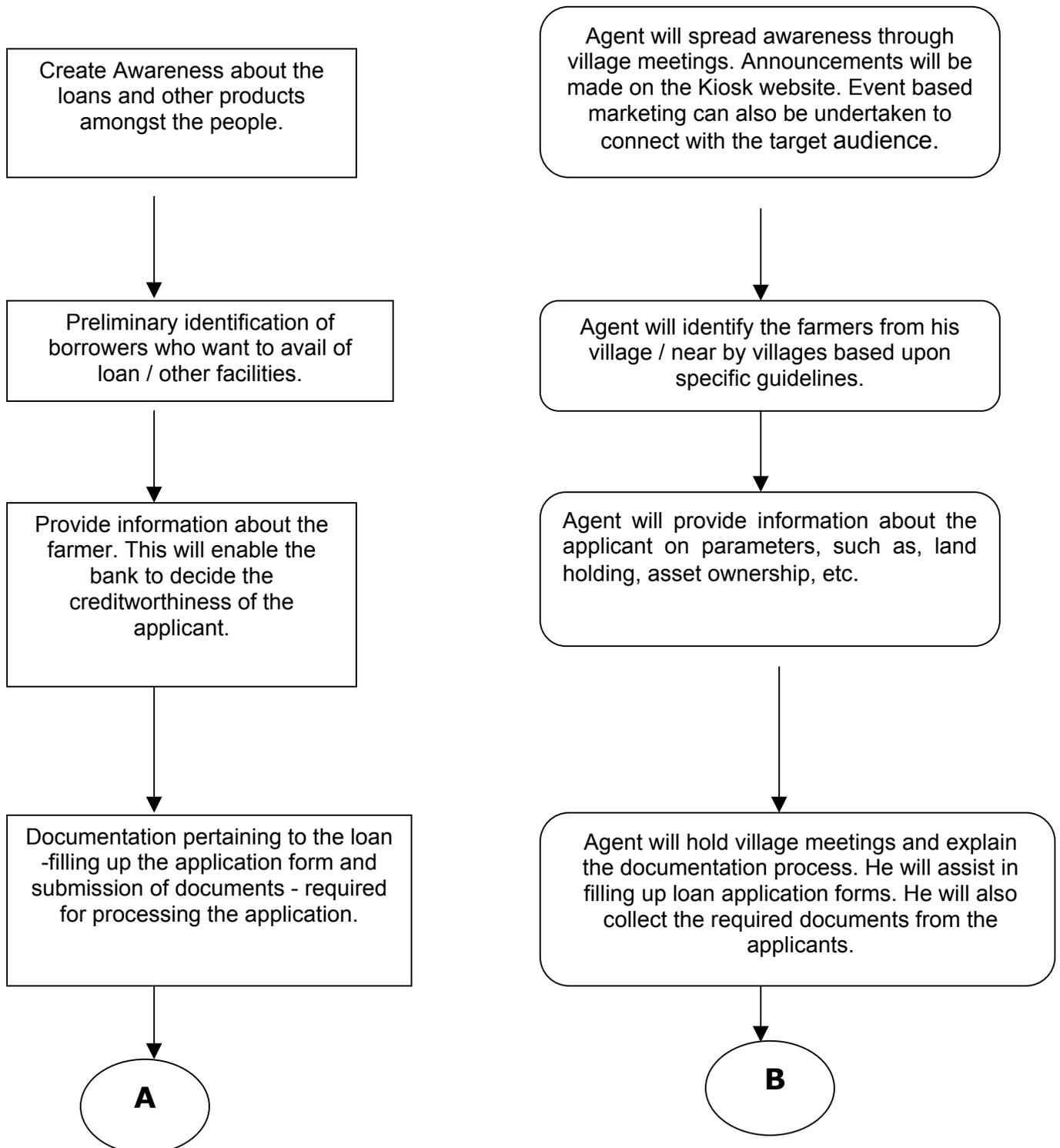
PoS= Point of Sale

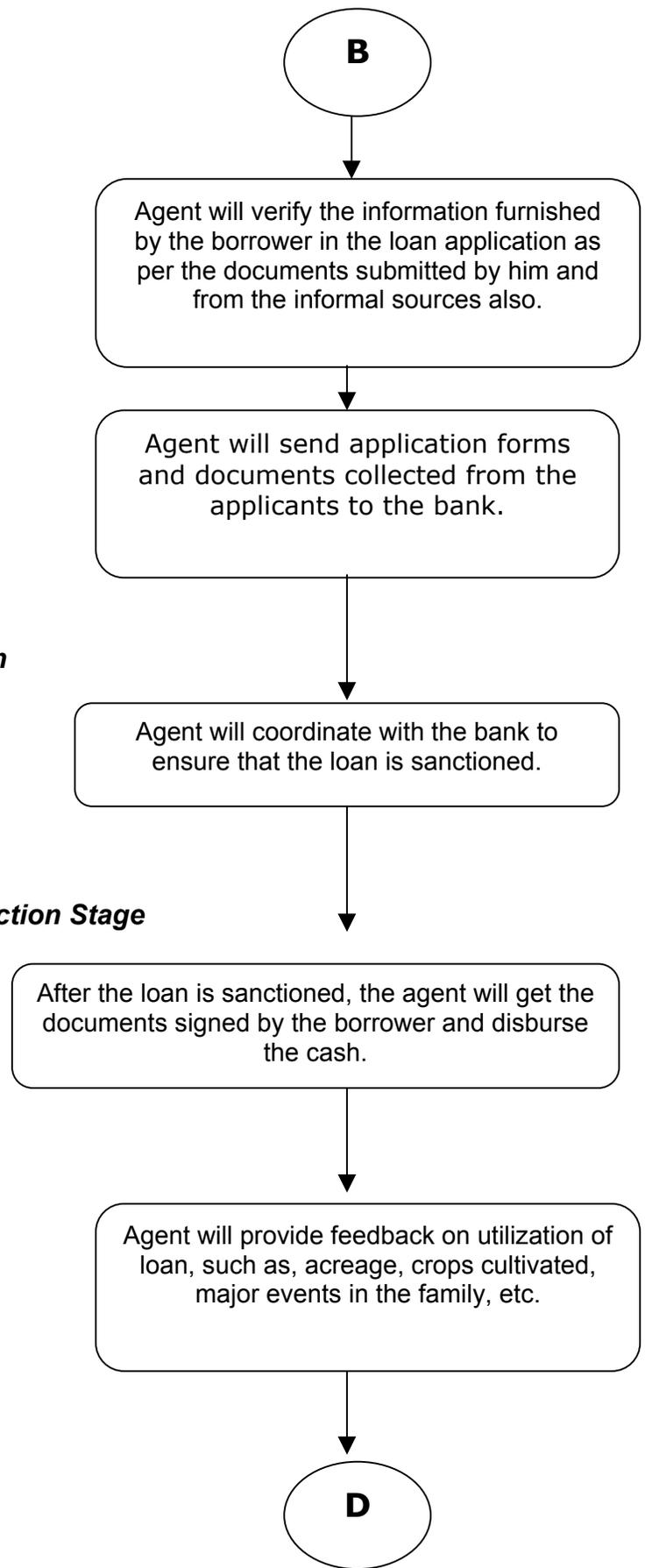
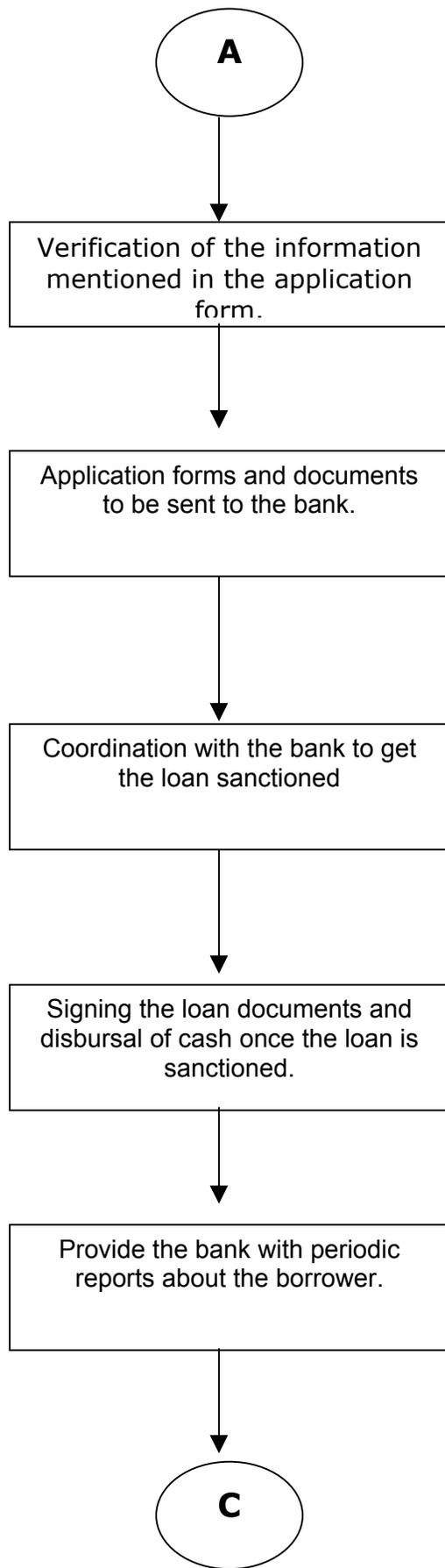
Illustrative Flowchart on Corporate-Bank Linkage Through IT Enabled Outlets

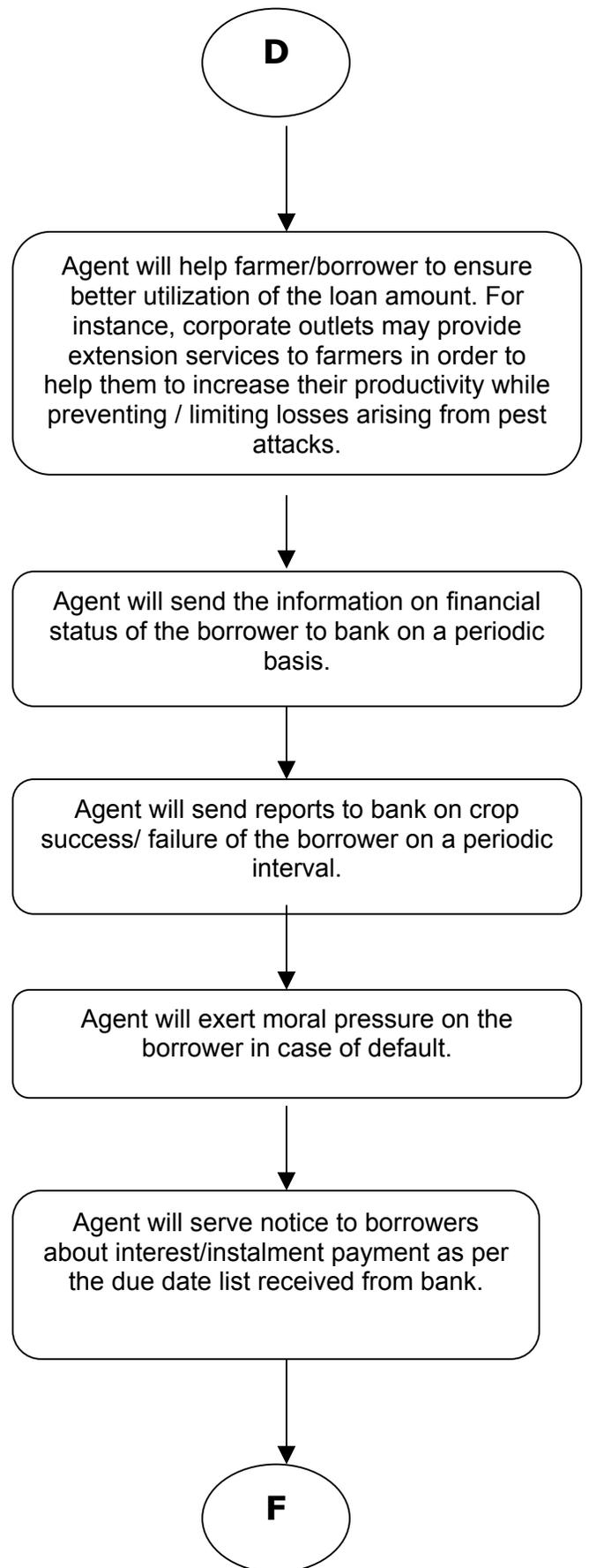
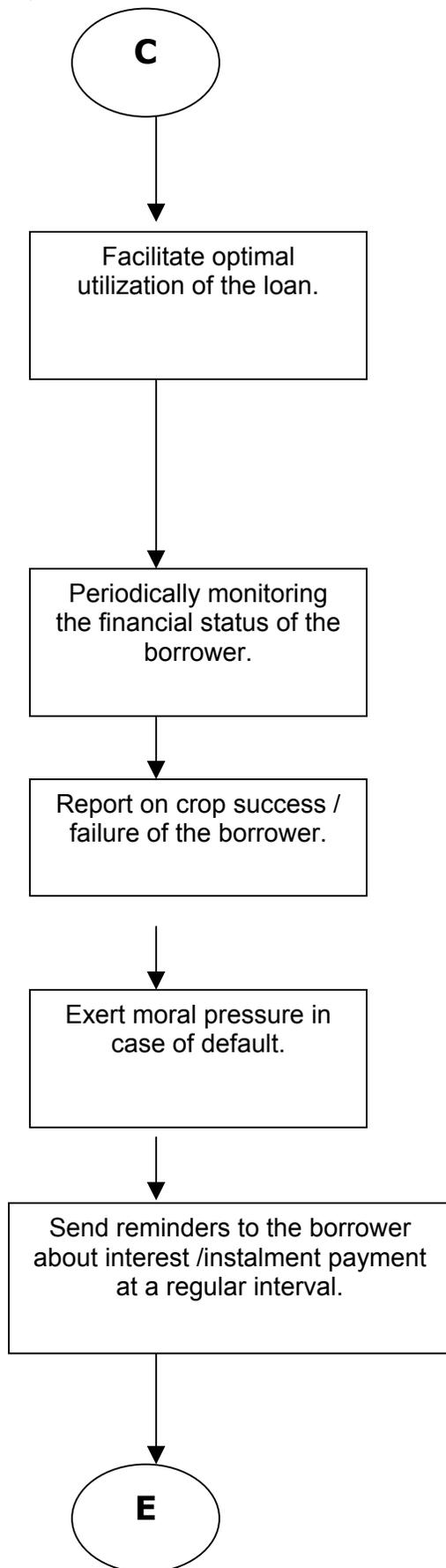
Banking Functions

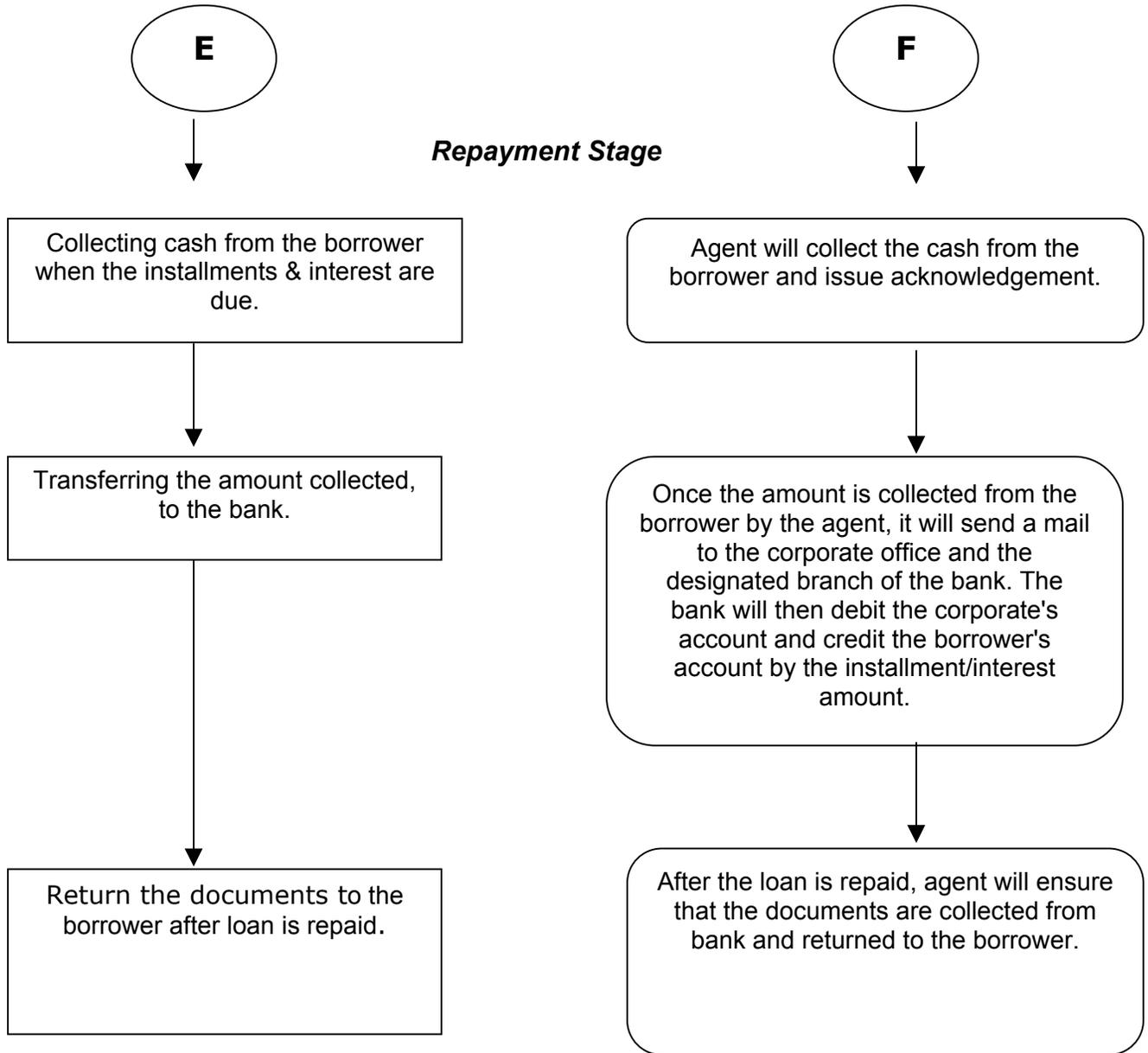
Role of Corporate Agent at the outlet

Pre- Sanction Stage









Comparison of Rating Models

Rating Agency	Key Rating Parameters	Objectives/ Focus	Remarks
ACCIONs CAMEL	Capital Adequacy Asset Quality Management Earnings Liquidity	Internal assessment and Management Tool	Results are confidential
WOCCU – PEARLS (World Council of Credit Unions)	45 financial ratios grouped under six areas of Financial Performance Protection	Evaluate and monitor financial stability	Shared among members Credit Union and National Associations
Planet Rating's GIRAFE	26 indicators grouped under 6 areas : <ul style="list-style-type: none"> • Governance and decision rating process • Information and Management tools • Risk analysis and control • Assets including loan portfolio, • Funding, • Efficiency and Profitability 	Focus on Management	Available to all based on clients desire.
Micro Rate	<ul style="list-style-type: none"> • Lending operations and portfolio quality • Organisation and MIS • Asset quality, growth and performance • Management • Governance 	Focus on Risks Provide industry peer comparison	-
M-CRIL (India)	30 indicators in 3 main areas : <ul style="list-style-type: none"> • Organisational and Governance aspects • Managerial and Resource Strength • Financial Performance 	Main focus on credit risk and repayment capacity	Does bench-marking of a few key parameters based on M-CRIL's existing database
CRISIL's MICROs (India)	<ul style="list-style-type: none"> • Management • Institutional Arrangement • Capital Adequate and Asset Quality • Resources • Operational Effectiveness • Scalability & Sustainability 	Focus on Credit worthiness, Scalability and Sustainability	

Regulation of Microfinance Sector :
Gist of Recommendations of previous Committees/ Groups

1. The *Task Force on Supportive Policy and Regulatory Framework for Micro finance (Task Force) chaired by NABARD (1999)* had, among others, favoured self-regulation by the micro finance institutions through self regulatory organisations (SROs). The Task Force recommended a classification of MFIs based on whether they offered deposit facilities or not and a graded system of external supervision depending on the amount and source of deposits.

2. The *Internal Group on Micro Finance Regulatory Issues (2003)* set up by RBI looked at the micro finance sector as a multi tiered structure consisting of SHGs, NGOs, Micro Credit Institutions and Micro Finance Institutions. It favoured the lending agency to intensify monitoring of the SHGs so as to ensure that the groups do not lend outside the group, establish maximum exposure norms per individual in the group and annual rating by the banks to ensure that there are no slippages. In case of the NGOs, it recommended that the entities that have started lending convert themselves as cooperative societies under the Mutually Aided Cooperative Societies (MACS) or section 25 companies or NBFCs. It advised that the NGOs should stop taking deposits, place a credit cap of Rs. 50,000/- per member and have transparency in pricing. It recommended inclusion of SHGs as eligible to be members of section 25 companies and also recommended strict prudential and accounting norms. According to the Internal Group, the micro finance institutions are those who are permitted to collect public deposits and lend. It suggested various prudential norms and transparency in accounting with appropriate disclosures. It also recommended that micro finance institution may be allowed to become an NBFC with a reduced entry level capital of Rs. 25 lakh if they are exclusively financing SHGs but may be permitted to accept deposits only if the capital is Rs. 200 lakh.

3. Earlier the *Empowered Committee constituted by the Prime Minister's Office on Financial Flows to the Unorganized Sector* also made several recommendations regarding regulation of micro finance institution. The sub-group of the Empowered Committee on 'Addressing the Legal and Regulatory Challenges' (2002) while

recognizing the need for graded regulation for NGO-MFIs, suggested full-fledged regulation of MFIs over a specified period of time. The sub-group also suggested various amendments to the Income Tax Act and legislation on the lines of the Mutually Aided Cooperative Societies Act of Andhra Pradesh. It favoured larger loan ceiling for SHGs and making SHGs members of section 25 companies. It suggested incorporation of a new category of NBFC by RBI with minimum operational capital of Rs.25 lakh and the such NBFCs may be permitted to mobilize saving from members / borrowers in an incremental ratio of savings to NOF from 1:1 to 1:5 overtime.

4. The *Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System* set up by RBI under Prof. V.S.Vyas (2004) did not find it expedient to bring any new regulating framework nor did it favour deposit raising by unregulated entities to protect the interest of the depositors. The Advisory Committee indicated that as 'Not for Profit' MFIs do not accept public deposits, they need not be regulated by RBI.