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CONTENTS

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   FINDINGS

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FINANCIAL AND TAXATION ISSUES OF MICRO FINANCE BILL 2012: A MOVE TOWARDS RESPONSIBLE MICROFINANCE IN INDIA

DR DHARUV PAL SINGH
ASSOCIATE PROFESSOR
DEPARTMENT OF COMMERCE
GOVERNMENT POST GRADUATE COLLEGE
HAMIRPUR

ABSTRACT

Indian microfinance sector is witnessing a movement towards greater regulatory clarity following the crises in Andhra Pradesh. The microfinance institutions (Development and Regulation) Bill 2012 introduced in the parliament on 22nd of May comes with modifications to the earlier Bill introduced in 2007. The introduction of this bill brings a much needed strengthening of regulatory framework and consumer protection norms of the microfinance industry in India. This paper examined the financial and taxation issues in this Bill and found the potential to herald the next stage of microfinance growth in India. The designation of RBI as the sole regulator would be a positive step forward for the sector. Though the specifics of regulation for financial and taxation are yet to be determined. If the bill passes, a great challenge will remain; RBI must effectively regulate and monitor a great number of microfinance institutions that have previously been subject to very little regulation.

KEYWORDS
Bill, Financial, Microfinance, Taxation.

INTRODUCTION
Micro finance is most fundamentally the provision of credit without collateral, usually in relatively small amounts and for short periods of time. The excitement around microfinance has generally been based on the perception that it allows formal financial institutions to enter into forms of lending that are otherwise dominated by informal arrangements, such as traditional money lenders. Micro finance is the extension of financial services, notably small loans, to low income groups. It can serve as a vehicle for financial inclusion. Regular banks tend not to lend to the poor because of the high cost per individual loan and lack of collateral. In India, micro finance overcomes these issues by lending to Self Help Groups (SHGs), i.e., groups of pooled borrowings, and Joint Liability Groups (JLGs), i.e., groups of pooled liability. Delivery largely takes place through two mechanisms: the National Bank for Agriculture and Rural Development (NABARD) sponsored SHG Bank Linkage programme, where banks lend directly to SHGs and through micro finance institutions (MFIs) lending to SHGs, JLGs, rural banks and individual clients. Taken together, the Banks-SHG programme and MFIs reached 76.7 million people in 2010-11, a 71% growth over 2006-07.[1]

In order to regulate the sector, the government introduced the Micro Financial Sector (Development and Regulation) Bill, 2007, which designated NABARD as the regulator. This Bill lapsed with the dissolution of the 14th Lok Sabha. In 2010, following allegations of aggressive debt-recovery methods by MFIs, the Andhra Pradesh government passed an Act regulating MFI activity in the state. Following this, the RBI appointed the Malegam Committee to study issues and concerns in the sector.[2] Based on the recommendations of the committee, RBI created a separate category of NBFCs (NBFC – MFIs) in December, 2011. All NBFCs providing micro finance services come under RBI's regulations. The Committee also recommended introducing legislation to regulate the sector (Malegam Committee's recommendations). In May 2012, the Micro Finance Institutions (Development and Regulation) Bill was introduced in the Lok Sabha.

OBJECTIVE OF STUDY
In this paper, we will analyze the financial and taxation issues of the Micro Financial Institutions (Development and Regulation) Bill 2012. This bill to provide for development and regulation of the micro finance institutions for the purpose of facilitating access to credit, thrift and other micro finance services to the rural and urban poor and certain disadvantaged sections of the people and promoting financial inclusion through such institutions and for matters connected therewith or incidental thereto.

ORGANISATIONAL STRUCTURE
MFIs exist in various forms such as societies, trusts, co-operatives and non-banking financial companies (NBFCs). Most of the MFI's operating in India functions as charitable institutions. Therefore such organizations are registered under the various trust laws in force in various states, Societies registration Act 1860, Co-operative Societies Acts, and Indian Trust Act 1882. Some of them are registered under section 25 of the Companies Act 1956 and quite few of them register their trust deeds under the Indian Registration Act 1908. The above organizations describe themselves as charitable organizations because they are involved in the yeomen service of poverty alleviation through the medium of micro finance. These are known as not –for- profit organizations. Yet another MFI's are functioning purely as commercial organizations and they have no claim that they are involved in charities. Most of them are registered as Non-Banking Financial Companies (NBFC) which are strictly regulated by the Reserve Bank of India (RBI). There are Local Area Banks (LAB) also. These are known as For-profit micro finance organizations. In terms of market share, NBFCs dominate the industry, accounting for an estimated 90% of loan volume in 2010-11.[2] NBFC-MFIs are regulated by the Reserve Bank of India (RBI) Act, 1934. There is no statute regulating the rest of the microfinance industry consisting of societies, trusts and co-operatives.

REGISTERING MICRO FINANCE INSTITUTIONS
1. The Bill requires any institution providing micro finance services to register with the RBI. The RBI should be certain that the institution will engage in providing micro finance services and have a net-owned fund (aggregate of paid up capital and reserves) of at least Rs 5 lakh.
2. All organizations providing micro finance services will have to register within three months of the Act's commencement. Existing organizations registered with the RBI as an NBFC may continue to engage in micro finance activities subject to the rules and regulations issued by the RBI.
3. Certificates of registration may be cancelled by the RBI if MFIs cease to provide micro finance services or fail to comply with any condition imposed by the RBI. MFIs can appeal to the central government against any rejection or cancellation of certificate.

FINANCIAL ISSUES
1. Registered MFIs will have to create a reserve fund containing an RBI-specified percentage of net profit or surplus. The fund can only be used for purposes specified by the RBI. NBFCs registered with the RBI are not obliged to create this reserve fund.
2. The RBI can set a maximum limit on the interest rate an MFI can charge for micro credit facilities and the margin an MFI can make. In addition, the RBI can set a ceiling on the amount of loans given to clients and the number of individual clients an MFI has. The RBI can specify the tenure of micro credit facilities

and other terms and conditions like periodicity of repayment schedules. MFIs will have to provide a breakdown of interest rates, processing fees or other charges on the loan document.
3. For deposit acceptance, the RBI can provide directions relating to prudential norms like capital adequacy based on risk weights, accounting standards and deployment of funds.
4. Any MFI restructuring, amalgamation or closure will have to be approved by the RBI.

MICRO FINANCE DEVELOPMENT FUND
The RBI will create a Micro Finance Development Fund comprising of government grants, sums raised by donors and the public and any interest made out of investments. The Fund shall be used to provide loans, refinance, grant seed capital or any other micro credit facilities to any MFI. The fund can also be used to invest in existing MFIs.
The interest rates charged by MFIs for loans are usually much higher than the rates charged by banks. This is because the cost structures of MFIs are higher than that of banks on two counts. Firstly, funding for MFIs is costlier; for example in 2009-10 the average cost of funds for MFIs was 9.3% (of the loan portfolio) [3] while for banks the equivalent figure was 5.1%.[4] Secondly, MFI loans are smaller; individual loans typically range between Rs 10,000 and Rs 15,000.[2] Consequently, the transaction cost as a percentage of the loan is higher for MFIs. In 2009-10, operating costs, which include administrative and personnel costs, was 12.3% of the amount lent for MFIs, while the equivalent figure for banks was 1.8%.[3,4]
In order to prevent MFIs from charging excessive interest rates, the Bill enables RBI to set a limit on the interest rate and the margin (the difference between interest rates and cost of funds). In addition, RBI can specify the number of loans, size of loans and number of clients. Currently, the RBI has capped the margin at 10% for large NBFC MFIs (and 12% for the rest).[5]
The provision allowing RBI to set a cap on interest rates is designed to address an issue that arises from limited competition. In micro finance, the price of the product is the lending rate charged by an MFI. Price ceilings are introduced to prevent a monopoly or dominant power in the market from setting too high a price; an issue that comes under the purview of the Competition Commission of India (CCI). However, the Bill does not include any provision for RBI to consult the CCI when setting interest rates.

DEPOSITOR PROTECTION
The Bill permits MFIs to accept deposits. This would create an additional source of funding for MFIs, and also enable clients to have an option to save. However, depositor clients will bear the risk of default by an MFI, unlike borrower clients. Currently, banks and certain types of NBFCs can accept deposits and both are regulated by the RBI

DEPOSIT INSURANCE
The possibility of a financial institution defaulting and unable to repay deposits poses a significant risk to clients. Deposits in banks are protected, up to Rs 1 lakh, through the Deposit Insurance and Credit Guarantee Corporation. The Bill does not explicitly set out a similar provision for MFIs. Although the Bill requires MFIs to create a reserve fund which could potentially serve as protection for depositors, contributions to this fund are a percentage of profits or surplus. Consequently, any loss-making MFI would not have a fund, leaving depositors without a safety net.

CAPITAL REQUIREMENT
While the Bill gives RBI the authority to set prudential norms, it specifically lays out the requirement for a minimum net-owned fund of Rs 5 lakh for MFIs. It is not clear whether RBI will specify a higher net-owned fund requirement for deposit taking MFIs. In comparison, banks require a net owned fund of Rs 300 crore while public-deposit accepting NBFCs require Rs 2 crore.

BORROWER PROTECTION
One of the major issues arising from the micro finance crisis in Andhra Pradesh was the method of debt-recovery; it was felt to be too aggressive and forceful. According to the Malegam Committee, methods of debt recovery are the responsibility of MFIs and every MFI should establish a proper grievance redressal procedure.[2] The Bill provides for RBI to specify guidelines for fair and reasonable methods of recovery, but does not specify what this would entail. RBI has the power to issue directions to MFIs about observing codes of conduct and setting up MFI-specific grievance redressal mechanisms. In addition, it will also issue a code of conduct for field staff, laying out minimum qualifications and training tools. Currently the RBI has provided an NBFC Fair Practices Code[6] which issues directions on fair practices to NBFCs and in particular, NBFC-MFIs. With regard to debt-recovery, the RBI has specified that recovery should be made at a designated central place and recovery at place of residence should only happen when the borrower fails to appear at the central location.

INCLUSION OF INSURANCE AND PENSION UNDER MICRO FINANCE
Pensions and insurance services are included under the definition of micro finance services. Typically, MFIs provide these services acting as agents. Currently, the insurance sector is regulated by the Insurance Regulatory and Development Authority while the pension sector is regulated by Pension Fund Regulatory Development Authority. There is no mention of either regulator in the Bill. The 2007 Bill did include insurance and pension services under the definition of micro finance services. However, unlike the current Bill, the 2007 Bill explicitly stated that insurance and pension services would be regulated by the respective regulatory authorities.

ACCOUNTING ISSUES
The Bill empowers the RBI to issue directions to MFIs on prudential norms such as income recognition, accounting standards and capital adequacy. The designation of RBI as the sole regulator acknowledged as in charge of all aspects would lead to a great reduction of regulatory uniformity in accounting and taxation issues. These include:

STATUTE DRIVEN ACCOUNTING PRACTICES
As already indicated there are different organizational structures adopted by the MFI's. So the laws and legal formalities applicable to them would also differ. For e.g. MFI's registered under Section 25 of the Companies act are governed by that law whereas cooperative societies are governed by the cooperative societies act etc. Some trusts registered under the Indian trust act and others prepare and present the accounts according to their whims and fancies since such laws do not contain provisions relating to accounts. In such cases there is no uniformity in the matter of adoption of accounting practices and thus naturally such organizations prepare accounts according to their own needs and adopt their own practices. Therefore it can be noticed that the accounts prepared and presented are largely statute driven.

METHODS OF ACCOUNTING
It is a matter of common knowledge that there are two methods of accounting generally followed by the organizations including the MFI's. They are Cash system of accounting and Accrual system of accounting. A hybrid of the above two systems are also followed. In the case of cash system of accounting transactions are recorded when the relative cash receipts are actually received or when the expenses are actually paid out. Accrual system of accounting on the other hand would record transactions as when the right to receive the revenue arises or the liability to pay the expenditure is incurred. It is pertinent to note that under the Companies Act 1956 vide Section 209(3) (b) it is mandatory to follow the accrual system of accounting. It is to be noted that Section 145 of the Income Tax Act allows a person to follow either of the two methods. But accrual basis of accounting would be preferable since the same is more scientific and conceptually superior to cash system. Thus the MFI's are free to choose the method as may be found suitable to them except in the case of MFI's which are companies where it is compulsory to follow accrual system.

APPLICABILITY OF ACCOUNTING STANDARDS
Accounting standards are designed to apply to the general purpose financial statements and other financial reporting which are subject to the attest function of the members of the Institute of Chartered Accountants of India (ICAI). The ICAI is of the opinion that micro finance activities are of a commercial nature even though the objectives may be charitable or non- profit. Thus the various accounting standards issued by the ICAI are applicable to such MFI's and the same

would help maintaining the uniformity in the presentation of accounts. Even where the same is not applicable still it is recommended that the standards may be followed. As such Accounting Standards (AS) 1 to AS 7 and AS9 to AS31 shall be applicable to MFI'

FORMAT OF PROFIT AND LOSS ACCOUNT (INCOME AND EXPENDITURE ACCOUNT)

The Income of MFI's can be broadly classified into two groups as stated below.

Income from Financial Services and Other Income.

A) Income from Financial Services would include interest on loan, fees and service charges like training fee, loan processing fee, application fee etc., insurance commission and technical and consultancy fees.

B) Other Income would include grants received from various government and private institutions, interest on investments and miscellaneous income.

FORMAT OF THE BALANCE SHEET

The Balance sheet of an MFI may be drawn up in the manner described below.

Sources of Funds divided into broad 3 categories as Shareholders funds, Loan Funds and Deferred Tax liability. Shareholders' funds may be further divided into share capital or general capital fund and Reserves and surplus. Loan Funds may be classified as secured and unsecured. Those liabilities which fall due within a short period say one year may be shown as current liabilities.

Application of Funds divided into categories viz fixed assets, Loans and Advances, Investments, Current assets net of Current liabilities and miscellaneous items including Deferred Tax Assets.

TAXATION ISSUES

Already stated many of the MFI's are functioning as not-for- profit organizations and thus claim exemption under the Income tax act as organizations for charitable purposes. For this, the MFI's are required to get themselves registered under Section 12A of the said Act. If so the organizations shall be prima facie eligible for exemption from income tax. The claim is based on the ground that the main objectives sought to be achieved through micro finance activities are poverty alleviation and empowerment of rural poor especially women. But, of late, the Income tax department is taking the view that such organizations are not eligible for tax exemption since they are mere money lending agencies and are purely commercial organizations. To add to the existing fire Income tax Act has been amended in 2009 to say that those organizations whose objectives are advancement of any objects of general public utility shall not be eligible for tax exemption if it involves carrying on activities in the nature of trade commerce or business etc. Another issue is relating to non-availability of deductions towards bad debts which is a very normal incident in this area of activities, though NBFC' s are required to make provision for the same as per Reserve Bank guidelines.

FINDINGS

- The Bill seeks to provide a statutory framework to regulate and develop the micro finance industry.
- MFIs are defined as organizations providing micro credit facilities up to Rs 5 lakh, thrift collection services, pension or insurance services, or remittance services.
- The Bill requires that all MFIs to obtain a certificate of registration from the RBI. The applicant needs to have a net owned fund of at least Rs 5 lakh. By 'net owned fund' the Bill means the aggregate of paid up equity capital and free reserves on the balance sheet. The RBI should also be satisfied with the general character or management of the institution.
- Every MFI will have to create a reserve fund and the RBI may specify a percentage of net profit to add to this fund. There can be no appropriation from this fund unless specified by the RBI.
- The RBI has the authority to set the maximum annual percentage rate charged by MFIs and set a maximum limit on the margin MFIs can make. Margin is defined as the difference between the lending rate and the cost of funds (in percentage per annum).
- The Bill provides safeguards against misuse of market dominance by MFIs to charge excessive rates. It allows RBI to set upper limits on lending rates and margins. However, there is no provision for consultation with the Competition Commission of India.
- Any change in the corporate structure of a MFI, such as a shutdown, amalgamation, takeover or restructuring, can only take place with approval from the RBI.
- The Bill allows MFIs to accept deposits. Unlike banks, there is no facility for insuring customer deposits against default by MFIs. The minimum capital requirement is also lower, though RBI may prescribe higher requirements.
- The RBI shall create the Micro Finance Development Fund. Sums raised by the RBI from donors, institutions and the public along with the outstanding balance from the existing Micro Finance Development and Equity Fund form this fund. The central government, after due appropriation from Parliament, may grant money to this fund. The fund can provide loans, grants and other micro credit facilities to any MFI. The Development Fund for MFIs is to be managed by the RBI. The Bill also enables regulatory powers to be delegated to NABARD. Both these provisions could lead to conflict of interest.
- The Bill allows MFIs to provide pension and insurance services. However, it does not provide for regulation by or coordination of RBI with the respective sector regulators.
- The RBI is responsible for redressal of grievances for beneficiaries of micro finance services.
- The Bill allows the RBI to impose a monetary penalty of up to Rs 5 lakhs for any contravention of the Bill's provisions. No civil court will have jurisdiction against any MFI over any penalty imposed by the RBI.
- At the end of every financial year, MFIs are required to provide an annual balance sheet and profit and loss account for audit to the RBI. They will also have to provide a return detailing their activities within 90 days of the Bill being passed.
- The central government has the power to exempt certain MFIs from the provisions of the Bill.
- The Bill empowers the RBI to issue directions to MFIs on prudential norms such as income recognition, accounting standards and capital adequacy which would lead to a great reduction of regulatory uniformity in accounting and taxation issues. Which include:
  - The accounts prepared and presented are largely statute driven.
  - The MFI's are free to choose the method as may be found suitable to them except in the case of MFI's which are companies where it is compulsory to follow accrual system.
  - The ICAI is of the opinion that micro finance activities are of a commercial nature even though the objectives may be charitable or non- profit. Thus the various accounting standards issued by the ICAI are applicable to such MFI's and the same would help maintaining the uniformity in the presentation of accounts. Even where the same is not applicable still it is recommended that the standards may be followed. As such Accounting Standards (AS) 1 to AS 7 and AS9 to AS31 shall be applicable to MFI'
  - MFI's are required to get themselves registered under Section 12A of the income tax act as not for profit organizations (as organizations for charitable purposes) and thus can claim exemption.
  - Another issue is relating to non-availability of deductions towards bad debts which is a very normal incident in this area of activities, though NBFC' s are required to make provision for the same as per Reserve Bank guidelines.

CONCLUSION

The micro finance institutions (development and regulations) Bill 2012 addresses all legal forms of microfinance institutions which includes designation of RBI as the sole regulator and having power to regulate interest rate caps, margin caps, prudential norms, creation of micro finance development fund for investment, training, capacity building etc. The designation of RBI as the sole regulator would be a positive step forward for the sector. Though the specifics of regulation for financial and taxation are yet to be determined. If the bill passes, a great challenge will remain; RBI must effectively regulate and monitor a great number of microfinance institutions that have previously been subject to very little regulation. Let us hope for the best to emerge in the coming years.

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