MODULE -1

Evolution of financial services

Financial services are the economic services provided by finance industry which encompasses a board range of businesses that manage money including credit unions, banks, credit card companies insurance companies, accountancy companies, consumer finance companies, stock brokerages, investment funds, individual managers and some government sponsored enterprises.

History

The term "financial services" became more prevalent in the United States partly as a result of the Gramm-Leach-Bliley Act of the late 1990s, which enabled different types of companies operating in the U.S. financial services industry at that time to merge.[2]

Companies usually have two distinct approaches to this new type of business. One approach would be a bank which simply buys an insurance company or an investment bank, keeps the original brands of the acquired firm, and adds the acquisition to its holding company simply to diversify its earnings. Outside the U.S. (e.g. Japan), non-financial services companies are permitted within the holding company. In this scenario, each company still looks independent, and has its own customers, etc. In the other style, a bank would simply create its own brokerage division or insurance division and attempt to sell those products to its own existing customers, with incentives for combining all things with one company.

INDIAN FINANCIAL SYSTEM

The term financial system is a set of inter-related activities/services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, investment capital formation and growth.

Van Horne defined the financial system as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption.

According to Robinson, the primary function of the system is "to provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth

Features of Financial System:

- It plays a vital role in economic development of a country.
- It encourages both savings and investment.
- It links savers and investors.
- It helps in capital formation.
- It helps in allocation of risk.
- It facilitates expansion of financial markets.
- It aids in Financial Deepening and Broadening.

Core functions of a financial system

- A financial system provides a payments system for the exchange of goods and services.
- Provides a mechanism for the pooling of funds to undertake large-scale indivisible enterprise.
- Provides a way to transfer economic resources through time and across geographic regions and industries.
- Provides a way to manage uncertainty and control risk.
- Provides price information that helps coordinate decentralized decision-making in various sectors of the economy.
- Provides a way to deal with the asymmetric-information and incentive problems when one party to a financial transaction has information that the other party does not.

TYPES OF INDIAN FINANCIAL SYSTEM

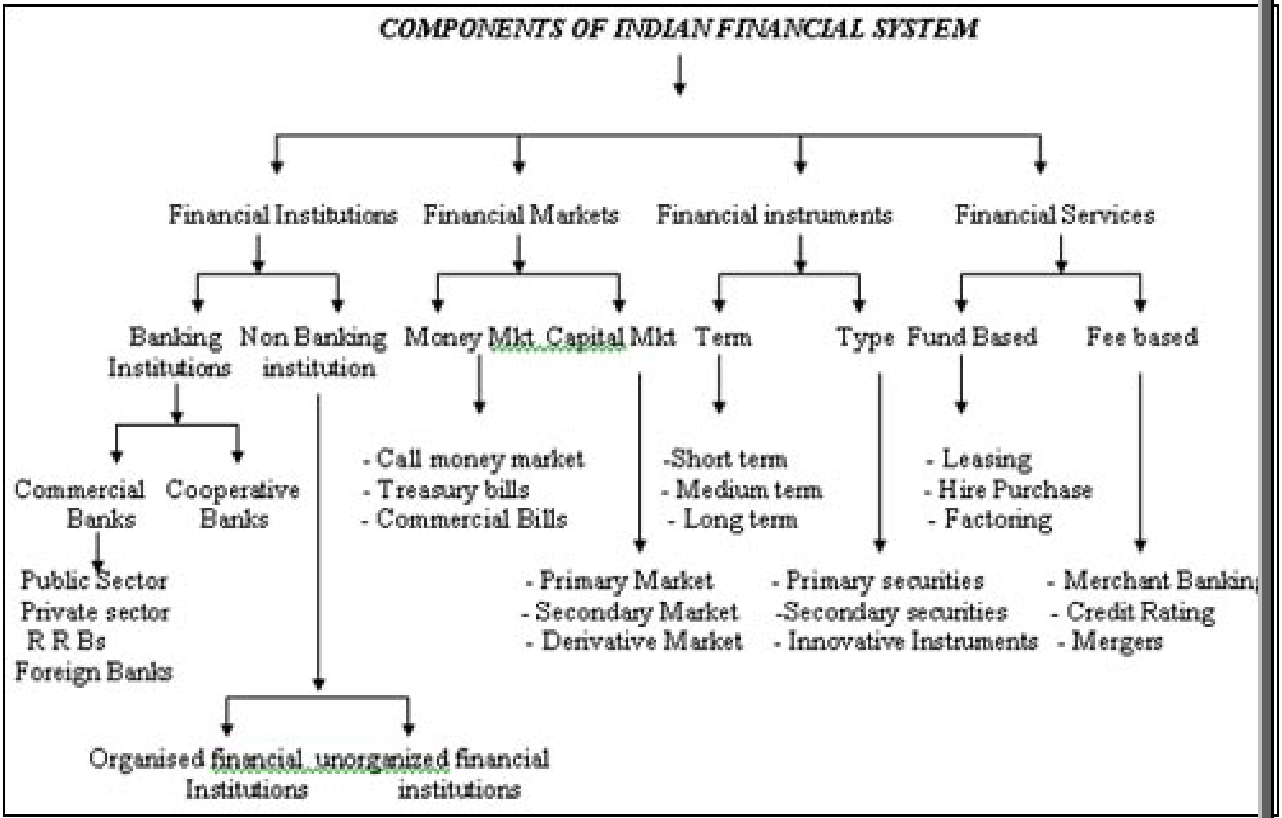
1. Formal
2. Informal

Diagram showing types of formal system

Structure of Indian Financial System

Financial structure refers to shape, components and their order in the financial system. The Indian financial system can be broadly classified into formal (organised) financial system and the informal (unorganised) financial system. The formal financial system comprises of Ministry of Finance, RBI, SEBI and other regulatory bodies. The informal financial system consists of individual money lenders, groups of persons operating as funds or associations, partnership firms consisting of local brokers, pawn brokers, and non-banking financial intermediaries such as finance, investment and chit fund companies.

The formal financial system comprises financial institutions, financial markets, financial instruments and financial services. These constituents or components of Indian financial system may be briefly discussed as below:



I. Financial Institutions

Financial institutions are the participants in a financial market. They are business organizations dealing in financial resources. They collect resources by accepting deposits from individuals and institutions and lend them to trade, industry and others. They buy and sell financial instruments. They generate financial instruments as well. They deal in financial assets. They accept deposits, grant loans and invest in securities.

Financial institutions are the business organizations that act as mobilises of savings and as purveyors of credit or finance. This means financial institutions mobilise the savings of savers and give credit or finance to the investors. They also provide various financial services to the community. They deal in financial assets such as deposits, loans, securities and so on. On the basis of the nature of activities, financial institutions may be classified as: (a) Regulatory and promotional institutions, (b) Banking institutions, and (c) Non-banking institutions.

1. Regulatory and Promotional Institutions: Financial institutions, financial markets, financial instruments and financial services are all regulated by regulators like Ministry of Finance, the Company Law Board, RBI, SEBI, IRDA, Dept. of Economic Affairs, Department of Company Affairs etc. The two major Regulatory and Promotional Institutions in India are Reserve Bank of India (RBI) and Securities Exchange Board of India (SEBI). Both RBI and SEBI administer, legislate, supervise, monitor, control and discipline the entire financial system. RBI is the apex of all financial institutions in India. All financial institutions are under the control of RBI. The financial markets are under the control of SEBI. Both RBI and SEBI have laid down several policies, procedures and guidelines. These policies, procedures and guidelines are changed from time to time so as to set the financial system in the right direction.

2. Banking Institutions: Banking institutions mobilise the savings of the people. They provide a mechanism for the smooth exchange of goods and services. They extend credit while lending money. They not only supply credit but also create credit. There are three basic categories of banking institutions. They are commercial banks, co-operative banks and developmental banks.

3. Non-banking Institutions: The non-banking financial institutions also mobilize financial resources directly or indirectly from the people. They lend the financial resources mobilized. They lend funds but do not create credit. Companies like LIC, GIC, UTI, Development Financial Institutions, Organisation of Pension and Provident Funds etc. fall in this category. Non-banking financial institutions can be categorized as investment companies, housing companies, leasing companies, hire purchase companies, specialized financial institutions (EXIM Bank etc.) investment institutions, state level institutions etc. Financial institutions are financial intermediaries. They intermediate between savers and investors. They lend money. They also mobilise savings.

II. Financial Markets

Financial markets are another part or component of financial system. Efficient financial markets are essential for speedy economic development. The vibrant financial market enhances the efficiency of capital formation. It facilitates the flow of savings into investment. Financial markets bridge one set of financial intermediaries with another set of players. Financial markets are the backbone of the economy. This is because they provide monetary support for the growth of the economy. The growth of the financial markets is the barometer of the growth of a country's economy. Financial market deals in financial securities (or financial instruments) and financial services. Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services. These are the markets in which money as well as monetary claims is traded in. Financial markets exist wherever financial transactions take place. Financial transactions include issue of equity stock by a company, purchase of bonds in the secondary market, deposit of money in a bank account, transfer of funds from a current account to a savings account etc. The participants in the financial markets are corporations, financial institutions, individuals and the government. These participants trade in financial products in these markets. They trade either directly or through brokers and dealers. In short, financial markets are markets that deal in financial assets and credit instruments. Functions of Financial Markets:

The main functions of financial markets are outlined as below

1. To facilitate creation and allocation of credit and liquidity.

2. To serve as intermediaries for mobilisation of savings.

3. To help in the process of balanced economic growth.

. To provide financial convenience.

5. To provide information and facilitate transactions at low cost.

6. To cater to the various credits needs of the business organisations.

Classification of Financial Markets: There are different ways of classifying financial markets. There are mainly five ways of classifying financial markets.

1. **Classification on the basis of the type of financial claim:** On this basis, financial markets may be classified into debt market and equity market.

Debt market: This is the financial market for fixed claims like debt instruments. Equity market: This is the financial market for residual claims, i.e., equity instruments.

2. **Classification on the basis of maturity of claims**: On this basis, financial markets may be classified into money market and capital market.

Money market: A market where short term funds are borrowed and lend is called money market. It deals in short term monetary assets with a maturity period of one year or less. Liquid funds as well as highly liquid securities are traded in the money market. Examples of money market are Treasury bill market, call money market, commercial bill market etc. The main participants in this market are banks, financial institutions and government. In short, money market is a place where the demand for and supply of short term funds are met.

Capital market: Capital market is the market for long term funds. This market deals in the long term claims, securities and stocks with a maturity period of more than one year. It is the market from where productive capital is raised and made available for industrial purposes. The stock market, the government bond market and derivatives market are examples of capital market. In short, the capital market deals with long term debt and stock.

3. **Classification on the basis of seasoning of claim**: On this basis, financial markets are classified into primary market and secondary market.

   Primary market: Primary markets are those markets which deal in the new securities. Therefore, they are also known as new issue markets. These are markets where securities are issued for the first time. In other words, these are the markets for the securities issued directly by the companies. The primary markets mobilise savings and supply fresh or additional capital to business units. In short, primary market is a market for raising fresh capital in the form of shares and debentures.

   Secondary market: Secondary markets are those markets which deal in existing securities. Existing securities are those securities that have already been issued and are already outstanding. Secondary market consists of stock exchanges. Stock exchanges are self regulatory bodies under the overall regulatory purview of the Govt. /SEBI.
4. **Classification on the basis of structure or arrangements:** On this basis, financial markets can be classified into organised markets and unorganized markets.

   Organised markets: These are financial markets in which financial transactions take place within the well established exchanges or in the systematic and orderly structure. Unorganised markets: These are financial markets in which financial transactions take place outside the well established exchange or without systematic and orderly structure or arrangements.
5. **Classification on the basis of timing of delivery**: On this basis, financial markets may be classified into cash/spot market and forward / future market.

Cash / Spot market: This is the market where the buying and selling of commodities happens or stocks are sold for cash and delivered immediately after the purchase or sale of commodities or securities.

Forward/Future market: This is the market where participants buy and sell stocks/commodities, contracts and the delivery of commodities or securities occurs at a pre-determined time in future.

6. **Other types of financial market:** Apart from the above, there are some other types of financial markets. They are foreign exchange market and derivatives market. Foreign exchange market: Foreign exchange market is simply defined as a market in which one country's currency is traded for another country's currency. It is a market for the purchase and sale of foreign currencies.

   Derivatives market: The derivatives are most modern financial instruments in hedging risk. The individuals and firms who wish to avoid or reduce risk can deal with the others who are willing to accept the risk for a price. A common place where such transactions take place is called the derivative market. It is a market in which derivatives are traded. In short, it is a market for derivatives. The important types of derivatives are forwards, futures, options, swaps, etc.

III. Financial Instruments (Securities)

Financial instruments are the financial assets, securities and claims. They may be viewed as financial assets and financial liabilities. Financial assets represent claims for the payment of a sum of money sometime in the future (repayment of principal) and/or a periodic payment in the form of interest or dividend. Financial liabilities are the counterparts of financial assets. They represent promise to pay some portion of prospective income and wealth to others. Financial assets and liabilities arise from the basic process of financing. Some of the financial instruments are tradable/ transferable. Others are non tradable/non-transferable The financial instruments may be capital market instruments or money market instruments or hybrid instruments.

Instruments of the Money Market:

The money market operates through a number of instruments.

1. Promissory Note:

The promissory note is the earliest types of bill. It is a written promise on the part of a businessman today to another a certain sum of money at an agreed future data. Usually, a promissory note falls due for payment after 90 days with three days of grace. A promissory note is drawn by the debtor and has to be accepted by the bank in which the debtor has his account, to be valid. The creditor can get it discounted from his bank till the date of recovery. Promissory notes are rarely used in business these days, except in the USA.

2. Bill of Exchange or Commercial Bills:
Another instrument of the money, market is the bill of exchange which is similar to the promissory note, except in that it is drawn by the creditor and is accepted by the bank of the debater. The creditor can discount the bill of exchange either with a broker or a bank. There is also the foreign bill of exchange which becomes due for payment from the date of acceptance. The rest of the procedure is the same as for the internal bill of exchange. Promissory notes and bills of exchange are known as trade bills.

3. Treasury Bill:
But the major instrument of the money markets is the Treasury bill which is issued for varying periods of less than one year. They are issued by the Secretary to the Treasury in England and are payable at the Bank of England. There are also the short-term government securities in the USA which are traded by commercial banks and dealers in securities. In India, the treasury bills are issued by the Government of India at a discount generally between 91 days and 364 days. There are three types of treasury bills in India—91 days, 182 days and 364 days.

4. Call and Notice Money:
There is the call money market in which funds are borrowed and lent for one day. In the notice market, they are borrowed and lent upto 14 days without any collateral security. But deposit receipt is issued to the lender by the borrower who repays the borrowed amount with interest on call. In India, commercial banks and cooperative banks borrow and lend funds in this market but mutual funds and all-India financial institutions participate only as lenders of funds.

5. Inter-bank Term Market:
This market is exclusively for commercial and cooperative banks in India, which borrow and lend funds for a period of over 14 days and upto 90 days without any collateral security at market-determined rates.

6. Certificates of Deposits (CD):

Certificates of deposits are issued by commercial banks at a discount on face value. The discount rate is determined by the market. In India the minimum size of the issue is Rs. 25 lakhs with the minimum subscription of Rs. 5 lakhs. The maturity period is between 3 months and 12 months.

7. Commercial Paper (CP):

Commercial papers are issued by highly rate companies to raise short-term working capital requirements directly from the market instead of borrowing from the banks. CP is a promise by the borrowing company to repay the load at a specified date, normally for a period of 3 months to 6 months. This instrument is very popular in the USA, UK, Japan, Australia and a number of other countries. It has been introduced in India in January 1990.

CAPITAL MARKET INSTRUMENTS

A capital market is a market for securities (debt or equity), where business enterprises and government can raise long-term funds. It is defined as a market in which money is provided for periods longer than a year, as the raising of short-term funds takes place on other markets (e.g., the money market). The capital market is characterized by a large variety of financial instruments: equity and preference shares, fully convertible debentures (FCDs), non-convertible debentures (NCDs) and partly convertible debentures (PCDs) currently dominate the capital market, however new instruments are being introduced such as debentures bundled with warrants, participating preference shares, zero-coupon bonds, secured premium notes, etc.

1. SECURED PREMIUM NOTES

SPN is a secured debenture redeemable at premium issued along with a detachable warrant, redeemable after a notice period, say four to seven years. The warrants attached to SPN gives the holder the right to apply and get allotted equity shares; provided the SPN is fully paid. There is a lock-in period for SPN during which no interest will be paid for an invested amount. The SPN holder has an option to sell back the SPN to the company at par value after the lock in period. If the holder exercises this option, no interest/ premium will be paid on redemption. In case the SPN holder holds it further, the holder will be repaid the principal amount along with the additional amount of interest/ premium on redemption in installments as decided by the company. The conversion of detachable warrants into equity shares will have to be done within the time limit notified by the company. Ex-TISCO issued warrants for the first time in India in the year 1992 to raise 1212 crore.

2. **DEEP DISCOUNT BONDS**

A bond that sells at a significant discount from par value and has no coupon rate or lower coupon rate than the prevailing rates of fixed-income securities with a similar risk profile. They are designed to meet the long term funds requirements of the issuer and investors who are not looking for immediate return and can be sold with a long maturity of 25-30 years at a deep discount on the face value of debentures. Ex-IDBI deep discount bonds for Rs 1 lac repayable after 25 years were sold at a discount price of Rs. 2,700.

3. EQUITY SHARES WITH DETACHABLE WARRANTS

A warrant is a security issued by company entitling the holder to buy a given number of shares of stock at a stipulated price during a specified period. These warrants are separately registered with the stock exchanges and traded separately. Warrants are frequently attached to bonds or preferred stock as a sweetener, allowing the issuer to pay lower interest rates or dividends. Ex-Essar Gujarat, Ranbaxy, Reliance issue this type of instrument.

4. **FULLY CONVERTIBLE DEBENTURES WITH INTEREST**

This is a debt instrument that is fully converted over a specified period into equity shares. The conversion can be in one or several phases. When the instrument is a pure debt instrument, interest is paid to the investor.

Financial service

Financial service include all those specialized services provided for borrowing and funding , lending, and investing buying and selling securities ,making and enabling payments and settlements and managing risk exposures in financial market.

Fund based activity: it refer to activities that are used to acquire assets or fund for a customer

Eg: lease financing, housing finance, factoring

Fee based services: managing the capital issue in accordance with sebi guidelines enabling promoters to market their issue. Making arrangements for arrangement for placement of capital and debt instruments with investment institution

Unorganised financial sector

The term **unorganised sector** when used in the Indian context is defined by National Commission for Enterprises in the Unorganised Sector, in their Report on Conditions of Work and Promotion of Livelihoods in the Unorganised Sector as .... consisting of all unincorporated private enterprises owned by individuals or households engaged in the sale or production of goods and services operated on a proprietary or partnership basis and with less than ten total workers Amongst the characteristic features of this sector are ease of entry, smaller scale of operation, local ownership, uncertain legal status, labour-intensive and operating using lower technology based methods, flexible pricing, less sophisticated packing, absence of a brand name, unavailability of good storage facilities and an effective distribution network, inadequate access to government schemes, finance and government aid, lower entry barriers for employees, a higher proportion of migrants with a lower rate of compensation. Employees of enterprises belonging to the unorganised sector have lower job security and poorer chances of growth, and no leaves and paid holidays, they have lower protection against employers indulging in unfair or illegal practices

Financial institution

An enterprise such as bank whose primary business and function is to collect m oney from the public and invest itin financialassets such as stocks and bonds, lo ans and mortgages, leases, and insurance policies**.**

A company that takes in money from individuals or companies and uses those funds to purchase financial assets such as deposits, loans, and securities as opposed to tangible property. Financial institutions are split into two types: depository and non-depository. Depository firms are banks, credit unions, and savings and loans that pay interest on deposits and then lend money in the form of interest-earning loans. Non-deposit firms offer pension funds, life and property/ casualty insurance policies, and retirement income in exchange for receiving premiums payments or contributions to retirement accounts from their clients.

Classification Or Types Of Financial Institutions :

In financial market there are many types of financial institutions or intermediaries exist for the flow of funds. Some of them involve in depositary type of transactions whereas other involve in non-depositary type of transactions. The type of financial institutions can be divided into two types as follows:

1. Depository Institutions

The depository types of financial institutions include banks, credit unions, saving and loan associations and mutual saving banks

*** Commercial banks**

Commercial banks are those financial institutions, which help in pooling the savings of surplus units and arrange their productive uses. They basically accepts the deposits from individuals and institutions, which are repayable on demand. These deposits from individuals and institutions are invested to satisfy the short-term financing requirement of business and industry.

*** Credit Unions**

Credit unions are cooperative associations where large numbers of people are voluntarily associated for savings and borrowing purposes. These individuals are the members of credit unions as they make share investment along with deposits. The saving generated from these members are used to lend the members of the union only.

*** Saving And Loan Associations**

Saving and loan associations are the financial institutions involved in collecting funds of many small savers and lending these funds to home buyers and other types of borrowers.

*** Mutual Saving Banks**

Mutual saving banks are more or less similar to saving and loan associations. They primarily accepts savings of individuals and they are lent to the home users and consumers on a long-term basis.

2. Non-depository Institutions

Non-depository institutions are not banks in real sense. They make contractual arrangement and investment in securities to satisfy the needs and preferences of investors. The non-depository institutions include insurance companies, pension funds, finance companies and mutual funds.

*** Insurance Companies**

Insurance companies are the contractual saving institutions which collect periodic premium from insured party and in return agree to compensate against the risk of loss of life and properties.

* Pension/Provident Funds

Pension funds are financial institutions which accept saving to provide pension and other kinds of retirement benefits to the employees of government units and other corporations. Pension funds are basically funded by corporation and government units for their employees, which make a periodic deposit to the pension fund and the fund provides benefits to associated employees on the retirement. The pension funds basically invest in stocks, bonds and other type of long-term securities including real estate.

* Finance Companies

Finance companies are the financial institutions that engage in satisfying individual credit needs, and perform merchant banking functions. In other words, finance companies are non-bank financial institutions that tend to meet various kinds of consumer credit needs. They involve in leasing, project financing, housing and other kind of real estate financing.

* Mutual Funds

Mutual funds are open-end investment companies. They are the associations or trusts of public members and invest in financial instruments or assets of the business sector or corporate sector for the mutual benefit of its members. Mutual funds are basically a large public portfolio that accepts funds from members and then use these funds to buy common stocks, preferred stocks, bonds and other short-term debt instruments issued by government and corporation.

Types of Loans granted by Financial Institution

-Secured Loan and

-Unsecured Loan

Secured loan:

A secured Loan is the Loan in which the borrower pledges some asset e.g. Gold, a Car or Property as collateral for the Loan, which then becomes a secured debt owed to the creditor who gives the Loan. The debt is thus secured against the collateral in the event where the borrower can default his/her payment than the creditor takes possession of the asset used as collateral and may sell it to regain some or all of the amount originally lent to the borrower. For example, foreclose is a portion of the bundle of rights to specified property. If the sale of the collateral does not raise enough money to pay off the debt, the creditor can often obtain a deficiency judgment against the borrower for the remaining amount. The opposite of secured debt /Loan is unsecured debt, which is not connected to any specific piece of property and instead the creditor may only satisfy the debt against the borrower rather than the borrower's collateral and the borrower.

Unsecured Loan :

Unsecured Loans are monetary Loans that are not secured against the borrower's assets
no collateral is involved. There are small business unsecured Loans such as credit cards and credit lines to large corporate credit lines. These may be available from Financial Institutions under many different guises or marketing packages.

- Personal Loans
- Bank overdrafts
- corporate bonds
- credit card debt
- credit facilities or lines of credit

Banking Company

Meaning:

According to Sec. 5 of the Banking Regulation Act, 1949, a banking company means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawn by Cheque, Draft, Order, or otherwise.

In short, a banking company means and includes any company which carries on the business or which transacts the business of banking in India. Therefore, any company which is engaged in trade or manufacture, which accepts deposits of money from the public for the purpose of financing its business only, shall not be deemed to carry on the business of banking.

No company can use as part of its name any of the words bank, banker or banking other than a banking company and, at the same time, no company can carry on business of banking in India unless and until it uses at least one of such words as part of its name.

Area of Business of Banking Companies:

Sec. 6 of the Banking Regulation Act, 1949, lays down that the following business may also be carried on by a banking company, in addition to the usual banking business:

(a) Acting as agents for any government or local authority or any other person or persons; the carrying on of agency business of any description including the clearing and forwarding of goods, giving of receipts and discharges and otherwise acting as an attorney on behalf of customers, but excluding the business of a managing agent of a company;

(b) Contracting for public and private loans and negotiating and issuing the same;

(c) Selecting, insuring, guaranteeing, underwriting, participating, in managing and carrying out of any issue, public or private, of state, municipal or other loans or of shares, stock, debentures or debenture stock of any company, corporation or association and of lending of money for the purpose of any such issue;

(d) Carrying on and transacting every kind of guarantee and indemnity business;

(e) Managing, selling and realizing any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims;

(f) Acquiring or holding and generally dealing with any property, or title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security;

(g) Undertaking and executing trusts;

(h) Undertaking the administration of estates as executor, trustee or otherwise;

(i) Establishing and supporting associations, institutions, funds, trusts, and convenience for the benefit of employees, ex-employees, their dependents and the general public;

(j) Acquiring, constructing, maintaining and altering any building or works necessary for the purpose of the banking company;

(k) Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing-off or turning into account or otherwise dealing with all or any part of the property and rights of the company;

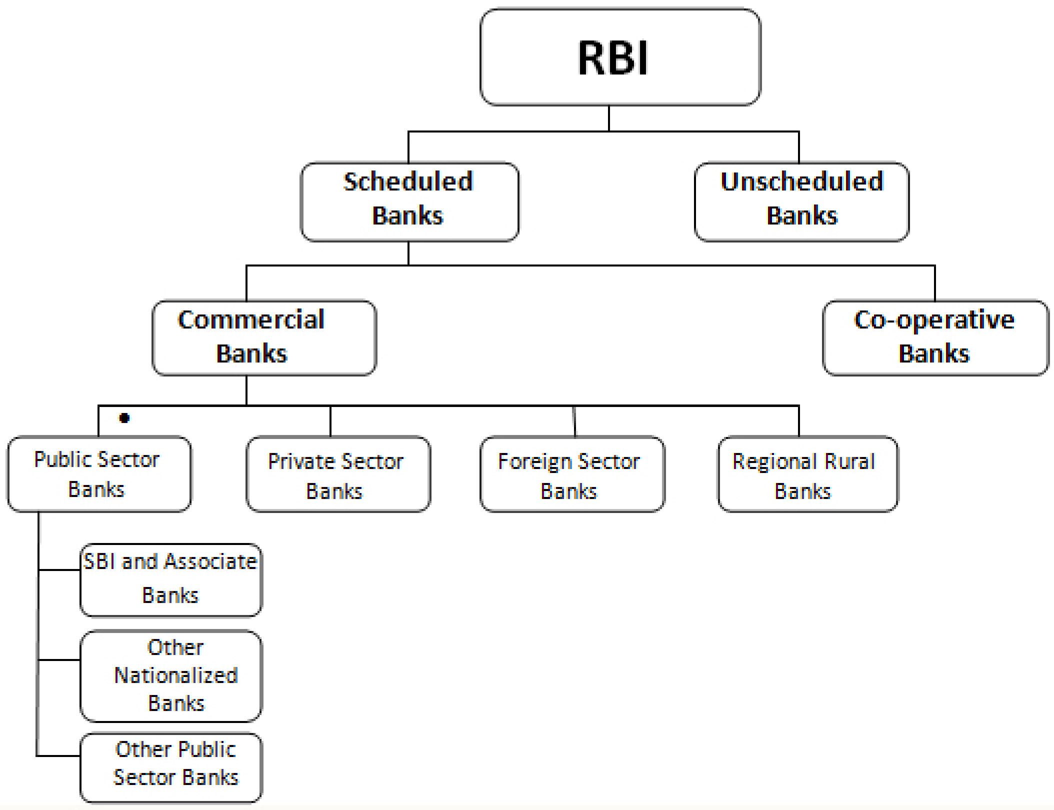
(l) Acquiring and undertaking the whole or any part of the business of any person or company when such business is of a nature enumerated or described in Sec. 6.

(m) Doing such other things as are necessary for the efficient conduct of the above-named business, such as acquisition, construction, alteration etc. of any building or works necessary or convenient for the purpose of the company; and

(n) Any other form' of business which the Central Government may notify in the Official Gazette.

As such, other types of business are prohibited by a banking company.

BANKING STRUCTURE IN INDIA



DIFFERENCE BETWEEN BANKS AND NBFCs

Banks and NBFC (Nonbanking financial banking company) are the key financial intermediaries which offer the same services to the customers. Finance is the basic requirement of an individual as well as businesses. NBFC is a compliment to the bank because banks alone are not able to serve the requirement of all.

Banks

- Banks are the financial institutions which are empowered by the government to do financial activities like to accept a deposit, Grant credit, to manage withdrawals pay interest, to clear cheques, to provide general services to the clients.
- Banks are the top organization which controls the whole financial system of the country.

- Banks act as a financial mediator between the depositors and the borrowers.
- Banks are responsible for the creating credit, mobilization of funds, safe and time bound transfer of finance.
- Banks help in smooth functioning of the economy.

NBFC

- NBFC is a company which is registered under the companies act, 1956 and it is under the control of central bank (Reserve bank of India).
- NBFC is not a bank but it is engaged in a lending fund as well as many other activities which are similar to banking like to provide loans and advances, credit facility, saving and various schemes etc.
- NBFC also provides services to the business corporation like an acquisition of shares, stocks, debentures, bonds, and securities issued by the government.
- It also facilitates services like hire purchase, leasing, venture capital finance, housing finance, and insurance

Difference between Banks and NBFC

Basis	Banks	NBFC
Meaning	Bank is a government entitled financial intermediary which aims to provide banking services to customers.	NBFC is a company which provides services similar to banking services to people without holding a bank license.
Registered under	A bank is registered under banking regulation act, 1949.	NBFC is registered under company's act 1956.
Deposit	Banks accept and lend deposit.	NBFC do not accept and lend deposit.
Investment	In banks a foreign investment is limited up to a certain fixed limit.	In NBFC, Foreign investment is allowed up to 100 percent.
Payment system	Payment and settlement is the core activity of banks.	In NBFC, the payment system is not a part of the activity.
Demand draft	Bank can issue self-demand draft on itself.	NBFC cannot issue self-demand draft their own.

Cheque drawn	Banks can draw a self-cheque by their own.	NBFC cannot draw self-cheque their own.
Credit creator	Banks can create credit through multiplier financial activities.	NBFC cannot do it.
Transaction services	Bank provides a variety of transaction services.	NBFC does not facilitate transaction services.

MODULE – II

Syllabus:

History of Non Banking Financial Companies - Classification of Non Banking Companies, Classification of Activities of Non Banking Finance Companies - Fund Based Activities , Fee Based Activities – Concepts, Growth and Trends of Fee Based And Fund Based Activities.

History of NBFCs

Non-Banking Financial Companies are rising fast as an integral part of the Indian financial system. A non-banking financial institution (NBFI) or non-bank financial company (NBFC) does not have a full banking license but facilitate bank-related financial services like investment, contractual savings, and market brokering and risk pooling. They play a big role in strengthening the economy and have been able to carve out a place for themselves in meeting the credit needs of both wholesale and retail customers.

Role of NBFI in the financial system

- NBFIs act as a supplement to banks by providing infrastructure to distribute excess resources to individuals and companies with deficits.
- NBFIs also serve the additional purpose of introducing competition in financial services.
- Unlike banks who may offer a packaged deal on a set of financial services, NBFIs offer customized services to suit the specific needs of clients NBFIs specializing in one particular sector develop an informational advantage.
- From loans and credit facilities to private education funding and retirement planning, from trading in money markets to underwriting stocks and shares, and Term Finance Certificates, NBFCs offer almost all banking services. They provide wealth management services like managing stocks and shares portfolios, discounting services like discounting of instruments and give advice on merger and acquisition activities.
- The number of NBFCs has increased greatly in the last several years due to venture capital companies, retail and industrial companies have entered the lending business. NBFCs also often support property investments in property besides preparing feasibility, market or industry studies for companies.
- NBFCs are usually not allowed to take deposits from the general public and have

to find options for funding their operations.

- NBFCs do not provide cheque books nor do they provide a saving account and current account. They are only authorized to takes fixed deposit or time deposits.

Some of the key regulations for acceptance of deposits by the NBFCs are

- They are allowed to accept or renew public deposits for a minimum period of 12 months and a maximum period of 60 months.
- They cannot accept deposits repayable on demand.
- They cannot offer interest rates higher than the ceiling rate prescribed by RBI from time to time.
- They cannot offer gifts/incentives or any other additional benefit to the depositors.
- They should have the minimum investment grade credit rating
- Their deposits are not insured.
- RBI does not guarantee the repayment of deposits by NBFCs.

A brief history of NFBC

- NBFCs started humbly in India in the 1960s as an alternative for savers and investors whose financial needs were not sufficiently met by the existing banking system. The NBFCs initially operated on a limited scale without making much impact on the financial industry. They invited fixed deposits from investors and worked out leasing deals for big industrial firms.
- In the first stages of development, the Companies Act regulated financing. However, the unique and complex nature of operations and with financial companies acting as financial intermediaries, there was a call for a separate regulatory mechanism.
- Hence, Chapter III B was included in the Reserve Bank of India Act, 1934, which assigned the Bank with limited authorities to regulate deposit-taking companies. Since then the RBI has initiated measures to regulate the NBFC sector.
- The RBI accepted and implemented that hire purchase and leasing companies could accept deposits to the extent of their net owned funds, as per the key recommendations of James S. Raj Study Group formed in 1975. The Companies were also required to maintain liquid assets

in the form of unencumbered approved government securities.

- Between the 1980s and 1990s, NBFCs, with their customer-friendly reputation, began to attract a huge number of investors. The number of NBFCs rose swiftly from a mere 7000 in 1981 to around 30000 in 1992, which made the RBI feel the need to regulate the industry. In 1992, the RBI formed a Committee headed by the former Chairman of Bank of Baroda, Mr. A. C. Shah, to suggest measures for effective regulation of the industry. The Shah Committee's recommendations included most things from compulsory registration to prudential norms.
- In January 1997 there were huge changes in the RBI Act, 1934, especially the Chapters III-B, III-C, and V of the Act seeking to put in place a complete regulatory and supervisory structure, which would protect the interests and also ensure the smooth functioning of NBFCs.
- After the amendment of the Act in 1997, the NBFCs have grown significantly in terms of operations, range of instruments and market products, technological advancement, among others.
- In the last 20 years, the NBFCs have gained prominence and added depth to the financial sector. In August 2016, the union cabinet gave the go-ahead for foreign direct investment (FDI) under the automatic route in regulated NBFCs.

Classification of NBFCs

1. **Equipment Leasing Company**

Equipment leasing company is any financial institution whose principal business is that of leasing equipments or financing of such an activity.

Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments. The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the tenant and the landlord is called a tenancy, and can be for a fixed or an indefinite period of time (called the term of the lease). The consideration for the lease is called rent.

Advantages

- Avoidance of Initial Cash Outlay – without making capital investment in buying the assets.
- Convenience and Flexibility
- Minimum Delay
- Easy Sources of Finance
- Cost – Floatation, Maintenance and administrative
- Risk management

Disadvantages

- Higher Cost
- Risk of being Deprived of the Use of Asset
- No Alteration or Change in Asset
- Loss of Ownership incentives
- Penalties on Termination of Lease
- Loss of Salvage value of the asset

Example: Shriram Transport Finance Corporation

2. Hire-Purchase Company

Any financial intermediary whose principal business relates to hire purchase transactions or financing of such transactions. A method of buying goods through making installment payments over time. Under a hire purchase contract, the buyer is leasing the goods and does not obtain ownership until the full amount of the contract is paid. Hire purchase combines elements of both a loan and a lease. You reach an agreement with the dealer to pay an initial deposit, typically anything between 10% and 50%, and then pay off the balance in monthly installments over an agreed period of time. At the end of this period, the product is yours.

3. Investment Company

Investment Company is any financial intermediary whose principal business is that of buying and selling of securities. It is a company whose main business is holding securities of other companies purely for investment purposes. The investment company invests money on behalf of its shareholders who in turn share in the profits and losses.

The **Investment Companies** are the non-finance banking companies that are primarily engaged in the business of buying and selling of securities. Simply, a company that pools the resources of investors to reinvest it in the marketable securities ranging from shares to debentures to money market instruments are called the investment companies.

The investment companies hold the securities of other companies solely for making the investments. Here, the fund manager decides the type of security in which the pooled money is to be invested in order to have a diverse and a managed portfolio.

Basically, the investment companies are divided into three types:

- **Open-End Management Investment Company** also called as **Mutual Funds,** has no limit on the number of units the fund issues which means, the investor can continuously buy or redeem its shares at the current net asset value

(NAV). The Open-end mutual funds are more convenient for the investors since it enables them to buy as many shares as they want and can easily redeem it at their disposal.

- **Closed-End Management Investment Companies** also called as **Investment Trusts,** issues a fixed number of shares through initial public offerings. These are essentially the publicly traded companies that raise a fixed amount of capital through the issue of a fixed number of shares traded on the stock exchange. Here, the shares are limited and hence the investors cannot buy as many shares as they want and similarly they cannot sell their existing shares before the expiry of the scheme. But, however, if any investor seeks to sell his shares the same are traded on the stock exchange.
- **Unit Investment Trusts** also called as **Unit Trusts** share the similarities of both the closed end and open end mutual funds. Here also, the investment company holds the portfolio of stock, shares, debentures and other money market instruments purely for investment purposes. Like, open end funds, most of these can be bought and sold directly from the issuing investment company while in some instances these are also traded on the secondary market. Unit trusts often have a low minimum investment requirement and the shares can be bought and sold anytime the investor wants.

The investment companies give an advantage to the small investors to make the investments in the wide array of securities which otherwise could not have been possible.

Example: Mutual Fund Companies

4. Housing Finance Company

Providing finance to the individual or group of individuals for the purchase, construction, extension, combined loan for purchase of plot and construction etc. These companies are supervised by National Housing Bank, which refinances housing loans by scheduled commercial banks, co-operative banks, housing finance companies and the apex co-operative housing finance societies.

The shelter sector of the Indian financial system remained utterly underdeveloped till 1980. The lack of adequate institutional supply of credit for house building was the main gap in the process of financial development in India.

The Indian housing industry is highly fragmented, with the unorganized sector, comprising small builders and contractors, accounting for over 70% of the housing units constructed and the organized sector accounting for the rest. The organized sector comprises large builders and government or government affiliated entities.

Banks now control 40% of this market and continue to show explosive growth. Finance for housing is provided in the form of mortgage loans. The suppliers of house mortgage loans in India are: HUDCO, SHFSs, central and state governments, HDFC, Commercial Banks, LIC (Jeevan Kutir & Jeevan Niwas) and NHB.

5. Loan Company

Loan company means any financial institution whose principal business is that of providing finance, whether by making loans or advances or otherwise for any activity other than its own (excluding any equipment leasing or hire-purchase finance activity). A loan is a type of debt. Like all debt instruments, a loan entails the redistribution of financial assets over time, between the lender and the borrower.

The loan is a kind of an agreement wherein the lender temporarily lends property, usually cash to the borrower with a promise that the borrower will return it along with the interest as per the terms and conditions as agreed upon. The loan companies offer several kinds of loans based on the individual's preferences. Such as demand loan, term loan, secured loan, unsecured loan, industrial loan, commercial loan, agricultural loan, etc.

The loan companies are usually the small partnership firms that accept deposits from the public at high-interest rates and further give loans to the wholesalers, retailers, small scale firms, self-employed persons, etc. at a relatively higher rate of interest. The loan company does include any business activity which is performed by either the hire-purchase company or the equipment leasing company. Although the nature of all these companies is alike, their business activities are entirely different from each other and at the same time, the funding requirements of all vary significantly.

Types of loans:

Secured: A secured loan is a loan in which the borrower pledges some asset (e.g. a car or property) as collateral.

Unsecured: Unsecured loans are monetary loans that are not secured against the borrower's assets.

- Credit card debt
- Personal loans

- Bank overdrafts
- Corporate bonds (may be secured or unsecured)
- Demand: Demand loans are short term loans that are typical in that they do not have fixed dates for repayment and carry a floating interest rate which varies according to the prime rate. They can be "called" for repayment by the lending institution at any time. Demand loans may be unsecured or secured.

6. **Mutual Benefit Financial Company** (MBFC)

Nidhis or Mutual Benefit Finance Companies are one of the oldest forms of non-financial companies. It is a company structure in which the company's owners are also its clients. That is, the mutual company's profits are distributed to its participating customers each year in proportion to their individual exposures to the company. Many insurance companies are structured as mutual companies.

Some of the important objectives of Nidhis are to enable the members to save money, to invest their savings and to secure loans at favorable rates of interest. They work on the principles of complete mutuality of interest and are generally well-managed. The Government has granted certain concessions under Section 620A of the Companies Act, 1956. Primarily regulated by Department of Company Affairs (DCA) under the directions / guidelines issued by them under Section 637 A of the Companies Act, 1956. The Government of India constituted an Expert Committee in March 2000 (Chairman: Shri P.Sabanayagam)

The **Mutual Benefit Finance Companies** also called as **"Nidhis"**, are the non-banking finance companies that enable its members to pool their money with a predetermined investment objective. The main sources of funds are share capital, deposits from its members, deposits from the general public.

Often, the mutual benefit finance companies give loans to its members for several purposes such as marriages, child education, construction, repayment of old debts, etc. and offer several saving schemes. Also, it offers the credit facility to those members who are not able to raise funds from the commercial banks. Thus, the fundamental objective of Nidhis is to encourage members to save their money and secure loans at a considerable low-interest rate.

7. **Miscellaneous Non-Banking Companies** (MNBCS)

MNBCs are mainly engaged in the Chit Fund business. Conducting or supervising as a promoter, by which the company enters into an agreement with a specified number of subscribers that every one of them shall subscribe a certain sum in instalments over a definite period and that every one of such subscribers shall in turn, as determined by lot or by auction or by tender or in such manner as may be provided for in the arrangement, be entitled to the prize amount.

A chit scheme generally has a predetermined value and duration. Each scheme admits a particular number of members (generally equal to the duration of the scheme), who contribute a certain sum of money every month (or everyday) to the ’pot’. The ’pot’ is then auctioned out every month. The highest bidder (also known as the prized subscriber) wins the ’pot’ for that month. The bid amount is also called the ’discount’ and the prized subscriber wins the sum of money equal to the chit value less the discount. The discount money is then distributed among the rest of the members (or the non-prized subscribers)as ’dividend’ and in the subsequent month, the required contribution is brought down by the amount of dividend.

The Chit Fund companies have been exempted from all the core provisions of Chapter IIIB of the RBI Act including registration. In terms of Miscellaneous Non-Banking Companies (RB) Directions, the companies can accept deposits up to 25 per cent and 15 per cent from public and shareholders, respectively, for a period of 6 months to 36 months, but cannot accept deposits repayable on demand/notice.

8. **Residuary Non-Banking Companies** (RNBCS)

Company which receives deposits under any scheme or arrangement, by whatever name called, in one lumpsum or in instalments by way of contributions or subscriptions or by sale of units or certificates or other instruments, or in any manner are called RNBCs. RNBCs are a class of NBFCs which cannot be classified as equipment leasing, hire purchase, loan, investment, nidhi or chit fund companies, but which tap public savings by operating various deposit schemes. The deposit acceptance activities of these companies are governed by the provisions of Residuary Non Banking Companies (Reserve Bank) Directions, 1987

These directions include provisions relating to the minimum (not less than 12 months) and maximum period (not exceeding 84 months) of deposits, prohibition from forfeiture of any part of the deposit or interest payable thereon, disclosure requirements in the application forms and the advertisements soliciting deposits and periodical returns and information to be furnished to the Reserve Bank. Ten NBFCs are still functioning as RNBCs, the total deposits of which amounted to nearly Rs. 11,000 crore, constituting about 57.0 per cent of the total deposits of all reporting NBFCs.

9. Factoring

Factoring is defined as ‘a continuing legal relationship between a financial institution (the factor) and business concern (the client), selling goods or providing services to trade customers (the customers) on open account basis whereby the Factor purchases the client’s book debts (accounts receivables) either with or without recourse to the client and in relation thereto controls the credit extended to customers and administers the sales ledgers’.

A factor is a financial institution which manages the debt collection on behalf of its clients and bears the credit risks associated with these. For servicing the receivables and bearing the risk, the factor charges a fee which is usually 1-3 % of the face value of the receivables. As to the payment to the client, the factor may do so as the amount is collected, or he make an advance payment. In the later, the factor will charge an interest in addition to a fee.

Factoring mechanism

The parties involved in a factoring arrangement are:

1. The Client or the seller

2. The Debtor or the buyer

3. The Factor (International factoring may have a correspondent factor in addition to the domestic factor)

Classification of Activities of Non Banking Finance Companies

The financial activities are classified into two. They are

1. Fund based Activity:-It refers to activities that are used to acquire assets or a fund for a customer.

2. Fee based Activity:-When financial institutions operate in specialised fields to earn income in the form of fees, commission, brokerage or dividend.

Fund Based Activity

1. Equipment Leasing/Finance
2. Hire purchase and consumer credit

3. Bill Discounting
4. Venture Capital
5. Housing Finance
6. Insurance Services
7. Factoring etc.

Fee Based Activities

1. Issue Management
2. Portfolio Management
3. Corporate Counselling
4. Loan syndication
5. Merger and Acquisition
6. Capital Restructuring
7. Credit Rating
8. Stock Broking

Recent Trends in NBFC

1. Cloud Computing
2. Automation
3. Block chain
4. Artificial Intelligence and Cognitive Computing
5. Chat bots and Robo Advisors
6. Biometrics Aadhar based KYC
7. The idea of Social Score
8. Regulatory Changes
9. Operational Innovation and Growth
10. Varied Investment Strategies
11. Increased market activity with more registrations, approvals and listings
12. Sector to look out for

Module 3a
SOURCE OF FINANCE

There are various sources of finance such as equity, debt, debentures, retained earnings, term loans, working capital loans, letter of credit, euro issue, venture funding etc. These sources are useful in different situations. They are classified based on time period, ownership and control, and their source of generation.

ACCORDING TO TIME-PERIOD:

Sources of financing a business are classified based on the time period for which the money is required. Time period is commonly classified into following three:

LONG TERM SOURCES OF FINANCE

Long-term financing means capital requirements for a period of more than 5 years to 10, 15, 20 years or maybe more depending on other factors. Capital expenditures in fixed assets like plant and machinery, land and building etc of a business are funded using long-term sources of finance. Part of working capital which permanently stays with the business is also financed with long-term sources of finance. Long term financing sources can be in form of any of them:

- Share Capital or Equity Shares
- Preference Capital or Preference Shares
- Retained Earnings or Internal Accruals
- Debenture / Bonds
- Term Loans from Financial Institutes, Government, and Commercial Banks
- Venture Funding
- Asset Securitization
- International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR etc.

MEDIUM TERM SOURCES OF FINANCE

Medium term financing means financing for a period of 3 to 5 years and is used generally for two reasons. One, when long-term capital is not available for the time being and second, when deferred revenue expenditures like advertisements are made which are to be written off over a period of 3 to 5 years. Medium term financing sources can in the form of one of them:

- Preference Capital or Preference Shares
- Debenture / Bonds
- Medium Term Loans from
- Financial Institutes
- Government, and
- Commercial Banks
- Lease Finance
- Hire Purchase Finance

SHORT TERM SOURCES OF FINANCE

Short term financing means financing for a period of less than 1 year. The need for short-term finance arises to finance the current assets of a business like an inventory of raw material and finished goods, debtors, minimum cash and bank balance etc. Short term financing is also named as working capital financing. Short term finances are available in the form of:

- Trade Credit
- Short Term Loans like Working Capital Loans from Commercial Banks
- Fixed Deposits for a period of 1 year or less
- Advances received from customers
- Creditors
- Payables
- Factoring Services
- Bill Discounting etc.

ACCORDING TO OWNERSHIP AND CONTROL:

Sources of finances are classified based on ownership and control over the business. These two parameters are an important consideration while selecting a source of finance for the business. Whenever we bring in capital, there are two types of costs – one is the interest and another is sharing of ownership and control. Some entrepreneurs may not like to dilute their ownership rights in the business and others may believe in sharing the risk.

OWNED CAPITAL

Owned capital also refers to equity capital. It is sourced from promoters of the company or from the general public by issuing new equity shares. Promoters start the business by bringing in the required capital for a startup. Following are the sources of Owned Capital:

- Equity Capital
- Preference Capital
- Retained Earnings
- Convertible Debentures
- Venture Fund or Private Equity

Further, when the business grows and internal accruals like profits of the company are not enough to satisfy financing requirements, the promoters have a choice of selecting ownership capital or non-ownership capital. This decision is up to the promoters. Still, to discuss, certain advantages of equity capital are as follows:

It is a long term capital which means it stays permanently with the business.

There is no burden of paying interest or installments like borrowed capital. So, the risk of bankruptcy also reduces. Businesses in infancy stages prefer equity capital for this reason.

BORROWED CAPITAL

Borrowed capital is the capital arranged from outside sources. These include the following:

- Financial institutions,
- Commercial banks or
- The general public in case of debentures.

In this type of capital, the borrower has a charge on the assets of the business which means the company will pay the borrower by selling the assets in case of liquidation. Another feature of borrowed capital is regular payment of fixed interest and repayment of capital. Certain advantages of borrowing capital are as follows:

There is no dilution in ownership and control of business.

The cost of borrowed funds is low since it is a deductible expense for taxation purpose which ends up saving on taxes for the company.

ACCORDING TO SOURCE OF GENERATION:

INTERNAL SOURCES

Internal source of capital is the capital which is generated internally from the business. These are as follows:

- Retained profits
- Reduction or controlling of working capital
- Sale of assets etc.

The internal source has the same characteristics of owned capital. The best part of the internal sourcing of capital is that the business grows by itself and does not depend on outside parties. Disadvantages of both equity capital and debt capital are not present in this form of financing. Neither ownership dilutes nor fixed obligation / bankruptcy risk arises.

EXTERNAL SOURCES

An external source of finance is the capital generated from outside the business. Apart from the internal sources finance, all the sources are external sources of capital.

Deciding the right source of finance is a crucial business decision taken by top-level finance managers. The wrong source of finance increases the cost of funds which in turn would have a direct impact on the feasibility of project under concern. Improper match of the type of capital with business requirements may go against the smooth functioning of the business. For instance, if fixed assets, which derive benefits after 2 years, are financed through short-term finances will create cash flow mismatch after one year and the manager will again have to look for finances and pay the fee for raising capital again.

FINANCE FUNCTION

Investment Decision

One of the most important finance functions is to intelligently allocate capital to long term assets. This activity is also known as capital budgeting. It is important to allocate capital in those long term assets so as to get maximum yield in future. Following are the two aspects of investment decision

a. Evaluation of new investment in terms of profitability
b. Comparison of cut off rate against new investment and prevailing investment.

Since the future is uncertain therefore there are difficulties in calculation of expected return. Along with uncertainty comes the risk factor which has to be taken into consideration. This risk factor plays a very significant role in calculating the expected return of the prospective investment. Therefore while considering investment proposal it is important to take into consideration both expected return and the risk involved.

Investment decision not only involves allocating capital to long term assets but also involves decisions of using funds which are obtained by selling those assets which become less profitable and less productive. It wise decisions to decompose depreciated assets which are not adding value and utilize those funds in securing other beneficial assets. An opportunity cost of capital needs to be calculating while dissolving such assets. The correct cut off rate is calculated by using this opportunity cost of the required rate of return (RRR)

Financial Decision

Financial decision is yet another important function which a financial manger must perform. It is important to make wise decisions about when, where and how should a business acquire funds. Funds can be acquired through many ways and channels. Broadly speaking a correct ratio of an equity and debt has to be maintained. This mix of equity capital and debt is known as a firm's capital structure.

A firm tends to benefit most when the market value of a company's share maximizes this not only is a sign of growth for the firm but also maximizes shareholders wealth. On the other hand the use of debt affects the risk and return of a shareholder. It is more risky though it may increase the return on equity funds.

A sound financial structure is said to be one which aims at maximizing shareholders return with minimum risk. In such a scenario the market value of the firm will maximize and hence an optimum capital structure would be achieved. Other than equity and debt there are several other tools which are used in deciding a firm capital structure.

Dividend Decision

Earning profit or a positive return is a common aim of all the businesses. But the key function a financial manger performs in case of profitability is to decide whether to distribute all the profits to the shareholder or retain all the profits or distribute part of the profits to the shareholder and retain the other half in the business.

It's the financial manager's responsibility to decide a optimum dividend policy which maximizes the market value of the firm. Hence an optimum dividend payout ratio is calculated. It is a common practice to pay regular dividends in case of profitability Another way is to issue bonus shares to existing shareholders.

Liquidity Decision

It is very important to maintain a liquidity position of a firm to avoid insolvency. Firm's profitability, liquidity and risk all are associated with the investment in current assets. In order to maintain a tradeoff between profitability and liquidity it is important to invest sufficient funds in current assets. But since current assets do not earn anything for business therefore a proper calculation must be done before investing in current assets.

Current assets should properly be valued and disposed of from time to time once they become non profitable. Currents assets must be used in times of liquidity problems and times of insolvency.

INVESTMENT POLICY

An investment policy is any government regulation or law that encourages or discourages foreign investment in the local economy, e.g. currency exchange limits. Investment policy means a document that formalizes an institution's goals, objectives, and guidelines for asset management, investment advisory contracting, fees, and utilization of consultants and other outside professionals.

As globalization integrates the economies of neighboring and of trading states, they are typically forced to trade off such rules as part of a common tax, tariff and trade regime, e.g. as defined by a free trade pact. Investment policy favoring local investors over global ones is typically discouraged in such pacts, and the idea of a separate investment policy rapidly becomes a fiction or fantasy, as real decisions reflect the real need for nations to compete for investment, even from their own local investors. A strong and central criticism of the new global rules, made by many in the anti-globalization movement, is that guarantees are often available to foreign investors that are not available to local small investors, and that capital flight is encouraged by such free trade pacts.

RBI Guidelines For NBFC

Reserve Bank Of India Act, 1934(section45-IA). Requirement of registration and net owned fund.

(1) Notwithstanding anything contained in this Chapter or in any other law for the time being in force, no non-banking financial company shall commence or carry on the business of a non-banking financial institution without–

a) obtaining a certificate of registration issued under this Chapter; and
b) having the net owned fund of twenty-five lakh rupees or such other amount, not exceeding two hundred lakh rupees, as the Bank may, by notification in the Official Gazette, specify.

2) Every non-banking financial company shall make an application for registration to the Bank in such form as the Bank may specify:

> Provided that a non-banking financial company in existence on the commencement of the Reserve Bank of India (Amendment) Act, 1997 shall make an application for registration to the Bank before the expiry of six months from such commencement and notwithstanding anything contained in sub-section (1) may continue to carry on the business of a non-banking financial institution until a certificate of registration is

issued to it or rejection of application for registration is communicated to it.

(3) Notwithstanding anything contained in sub-section (1), a non-banking financial company in existence on the commencement of the Reserve Bank of India (Amendment) Act, 1997 and having a net owned fund of less than twentyfive lakh rupees may, for the purpose of enabling such company to fulfil the requirement of the net owned fund, continue to carry on the business of a nonbanking financial institution–

(i) for a period of three years from such commencement; or

(ii) for such further period as the Bank may, after recording the reasons in writing for so doing, extend, subject to the condition that such company shall, within three months of fulfilling the requirement of the net owned fund, inform the Bank about such fulfilment: Provided that the period allowed to continue business under this subsection shall in no case exceed six years in the aggregate.

(4) The Bank may, for the purpose of considering the application for registration, require to be satisfied by an inspection of the books of the non-banking financial company or otherwise that the following conditions are fulfilled:–

(a) that the non-banking financial company is or shall be in a position to pay its present or future depositors in full as and when their claims accrue;

(b) that the affairs of the non-banking financial company are not being or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors;

(c) that the general character of the management or the proposed management of the non-banking financial company shall not be prejudicial to the public interest or the interest of its depositors;

d) that the non-banking financial company has adequate capital structure and earning prospects;

e) that the public interest shall be served by the grant of certificate of registration to the non-banking financial company to commence or to carry on the business in India;

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

(g) any other condition, fulfilment of which in the opinion of the Bank, shall be necessary to ensure that the commencement of or carrying on of the business in India by a non-banking financial company shall not be prejudicial to the public interest or in the interest of the depositors.

(5) The Bank may, after being satisfied that the conditions specified in subsection (4) are fulfilled, grant a certificate of registration subject to such conditions which it may consider fit to impose.

(6) The Bank may cancel a certificate of registration granted to a non-banking financial company under this section if such company–

(i) ceases to carry on the business of a non-banking financial institution in India; or

(ii) has failed to comply with any condition subject to which the certificate of registration had been issued to it; or

(iii) at any time fails to fulfil any of the conditions referred to in clauses (a) to (g) of sub-section (4); or

(iv) fails–

(a) to comply with any direction issued by the Bank under the provisions of this chapter; or

(b) to maintain accounts in accordance with the requirements of any law or any direction or order issued by the Bank under the provisions of this Chapter; or

(c) to submit or offer for inspection its books of account and other relevant documents when so demanded by an inspecting authority of the Bank; or

(v) has been prohibited from accepting deposit by an order made by the Bank under the provisions of this Chapter and such order has been in force for a period of not less than three months:

Provided that before cancelling a certificate of registration on the ground that the non-banking financial company has failed to comply with the provisions of clause (ii) or has failed to fulfil any of the conditions referred to in clause (iii) the Bank, unless it is of the opinion that the delay in cancelling the certificate of registration shall be prejudicial to public interest or the interest of the depositors or the non-banking financial company, shall give an opportunity to such company on such terms as the Bank may specify for taking necessary steps to comply with such provision or fulfillment of such condition;

Provided further that before making any order of cancellation of certificate of registration, such company shall be given a reasonable opportunity of being heard.

(7) A company aggrieved by the order of rejection of application for registration or cancellation of certificate of registration may prefer an appeal, within a period of thirty days from the date on which such order of rejection or cancellation is communicated to it, to the Central Government and the decision of the Central Government where an appeal has been preferred to it, or of the Bank where no appeal has been preferred, shall be final:

Provided that before making any order of rejection of appeal, such company shall be given a reasonable opportunity of being heard.

Explanation.– For the purposes of this section,–

A. “net owned fund” means–

(a) the aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance-sheet of the company after deducting therefrom–

i. accumulated balance of loss;
ii. deferred revenue expenditure; and
iii. other intangible assets; and

(b) further reduced by the amounts representing–

(1) investments of such company in shares of–

i. its subsidiaries;
ii. companies in the same group;
iii. all other non-banking financial companies; and

(2) the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with,–

i. subsidiaries of such company; and
ii. companies in the same group, to the extent such amount exceeds ten per cent of (a) above.

B. “subsidiaries” and “companies in the same group” shall have the same meanings assigned to them in the Companies Act, 1956.

PRODUCTS OFFERED BY NBFCS IN INDIA

- **Funding for commercial vehicles**

The rate of interest for the commercial car loan depends on various factors like customer profiles and location.A commercial vehicle loan can be taken for a variety of commercial vehicles, which may be used at different locations. The commercial vehicle loan is applicable to customers with diverse profiles.

- **Retail financing**

Typical mass-market banking in which individual customers use local branches of larger commercial banks. Services offered include savings and checking accounts, mortgages, personal loans, debit/credit cards and certificates of deposit (CDs).

- **Loan against shares**

A loan against shares enables you to borrow funds against listed securities such as shares, mutual funds, insurance and bonds to meet current financial needs. Loan against shares is the best way to sort financial needs without liquidating assets.

- **Funding of plant and machinery**

It’s a versatile form of financing equipment used by many businesses – from large engineering firms to small parts manufacturers – because it keeps costs down and naturally helps to improve your cashflow position over the long term. Here’s more of the benefits of plant machinery finance:

1. Immediate access to machinery you need
2. Leasing options that suit how your firm trades
3. Hire Purchase options for title ownership after the period
4. Tax-efficient financing
5. Options to upgrade or update
6. Easier budgeting: fixed payments & fixed period
7. Plant machinery finance
8. Engineering machinery finance
9. Finance for machine tools and other equipment

- **Project finance**

financing of long-term infrastructure, industrial projects and public services based upon a non-recourse or limited recourse financial structure, in which project debt and equity used to finance the project are paid back from the cash flow generated by the project. Project financing is a loan structure that relies primarily on the project's cash flow for repayment, with the project's assets, rights and interests held as secondary security or collateral.

- **Unsecured personal loan**

An unsecured loan is a loan that is issued and supported only by the borrower's creditworthiness, rather than by any type of collateral. An unsecured loan is one that is obtained without the use of property as collateral for the loan.

- **Trade finance**

Trade finance signifies financing for trade, and it concerns both domestic and international trade transactions. A trade transaction requires a seller of goods and services as well as a buyer. Various intermediaries such as banks and financial institutions can facilitate these transactions by financing the trade. Trade finance relates to the process of financing certain activities related to commerce and international trade. Trade finance includes such activities as lending, issuing letters of credit, factoring, export credit and insurance. Companies involved with trade finance include importers and exporters, banks and financiers, insurers and export credit agencies, and other service providers.

- **Venture finance**

It is a type of financing by venture capital. It is private equity capital provided as seed funding to early-stage, high-potential, growth companies (startup companies) or more often it is after the seed funding round as a growth funding round .It is provided in the interest of generating a return on investment through an eventual realization event such as a trade sale of the company.

Module 3b

FINANCE FUNCTION

Investment Decision

One of the most important finance functions is to intelligently allocate capital to long term assets. This activity is also known as capital budgeting. It is important to allocate capital in those long term assets so as to get maximum yield in future. Following are the two aspects of investment decision

a. Evaluation of new investment in terms of profitability
b. Comparison of cut off rate against new investment and prevailing investment.

Since the future is uncertain therefore there are difficulties in calculation of expected return. Along with uncertainty comes the risk factor which has to be taken into consideration. This risk factor plays a very significant role in calculating the expected return of the prospective investment. Therefore while considering investment proposal it is important to take into consideration both expected return and the risk involved.

Investment decision not only involves allocating capital to long term assets but also involves decisions of using funds which are obtained by selling those assets which become less profitable and less productive. It wise decisions to decompose depreciated assets which are not adding value and utilize those funds in securing other beneficial assets. An opportunity cost of capital needs to be calculating while dissolving such assets. The correct cut off rate is calculated by using this opportunity cost of the required rate of return (RRR)

Financial Decision

Financial decision is yet another important function which a financial manger must perform. It is important to make wise decisions about when, where and how should a business acquire funds. Funds can be acquired through many ways and channels. Broadly speaking a correct ratio of an equity and debt has to be maintained. This mix of equity capital and debt is known as a firm's capital structure.

A firm tends to benefit most when the market value of a company's share maximizes this not only is a sign of growth for the firm but also maximizes shareholders wealth. On the other hand the use of debt affects the risk and return of a shareholder. It is more risky though it may increase the return on equity funds.

A sound financial structure is said to be one which aims at maximizing shareholders return with minimum risk. In such a scenario the market value of the firm will maximize and hence an optimum capital structure would be achieved. Other than equity and debt there are several other tools which are used in deciding a firm capital structure.

Dividend Decision

Earning profit or a positive return is a common aim of all the businesses. But the key function a financial manger performs in case of profitability is to decide whether to distribute all the profits to the shareholder or retain all the profits or distribute part of the profits to the shareholder and retain the other half in the business.

It's the financial manager's responsibility to decide a optimum dividend policy which maximizes the market value of the firm. Hence an optimum dividend payout ratio is calculated. It is a common practice to pay regular dividends in case of profitability Another way is to issue bonus shares to existing shareholders.

Liquidity Decision

It is very important to maintain a liquidity position of a firm to avoid insolvency. Firm's profitability, liquidity and risk all are associated with the investment in current assets. In order to maintain a tradeoff between profitability and liquidity it is important to invest sufficient funds in current assets. But since current assets do not earn anything for business therefore a proper calculation must be done before investing in current assets.

Current assets should properly be valued and disposed of from time to time once they become non profitable. Currents assets must be used in times of liquidity problems and times of insolvency.

INVESTMENT POLICY

An investment policy is any government regulation or law that encourages or discourages foreign investment in the local economy, e.g. currency exchange limits. Investment policy means a document that formalizes an institution's goals, objectives, and guidelines for asset management, investment advisory contracting, fees, and utilization of consultants and other outside professionals.

As globalization integrates the economies of neighboring and of trading states, they are typically forced to trade off such rules as part of a common tax, tariff and trade regime, e.g. as defined by a free trade pact. Investment policy favoring local investors over global ones is typically discouraged in such pacts, and the idea of a separate investment policy rapidly becomes a fiction or fantasy, as real decisions reflect the real need for nations to compete for investment, even from their own local investors. A strong and central criticism of the new global rules, made by many in the anti-globalization movement, is that guarantees are often available to foreign investors that are not available to local small investors, and that capital flight is encouraged by such free trade pacts.

RBI Guidelines For NBFC

Reserve Bank Of India Act, 1934(section45-IA). Requirement of registration and net owned fund.

(1) Notwithstanding anything contained in this Chapter or in any other law for the time being in force, no non-banking financial company shall commence or carry on the business of a non-banking financial institution without–

a) obtaining a certificate of registration issued under this Chapter; and
b) having the net owned fund of twenty-five lakh rupees or such other amount, not exceeding two hundred lakh rupees, as the Bank may, by notification in the Official Gazette, specify.

2) Every non-banking financial company shall make an application for registration to the Bank in such form as the Bank may specify:

Provided that a non-banking financial company in existence on the commencement of the Reserve Bank of India (Amendment) Act, 1997 shall make an application for registration to the Bank before the expiry of six months from such commencement and notwithstanding anything contained in sub-section (1) may continue to carry on the business of a non-banking financial institution until a certificate of registration is issued to it or rejection of application for registration is communicated to it.

(3) Notwithstanding anything contained in sub-section (1), a non-banking financial company in existence on the commencement of the Reserve Bank of India (Amendment) Act, 1997 and having a net owned fund of less than twentyfive lakh rupees may, for the purpose of enabling such company to fulfil the requirement of the net owned fund,

continue to carry on the business of a nonbanking financial institution–

(i) for a period of three years from such commencement; or

(ii) for such further period as the Bank may, after recording the reasons in writing for so doing, extend, subject to the condition that such company shall, within three months of fulfilling the requirement of the net owned fund, inform the Bank about such fulfilment: Provided that the period allowed to continue business under this subsection shall in no case exceed six years in the aggregate.

(4) The Bank may, for the purpose of considering the application for registration, require to be satisfied by an inspection of the books of the non-banking financial company or otherwise that the following conditions are fulfilled:–

(a) that the non-banking financial company is or shall be in a position to pay its present or future depositors in full as and when their claims accrue;

(b) that the affairs of the non-banking financial company are not being or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors;

(c) that the general character of the management or the proposed management of the non-banking financial company shall not be prejudicial to the public interest or the interest of its depositors;

d) that the non-banking financial company has adequate capital structure and earning prospects;

e) that the public interest shall be served by the grant of certificate of registration to the non-banking financial company to commence or to carry on the business in India;

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

(g) any other condition, fulfilment of which in the opinion of the Bank, shall be necessary to ensure that the commencement of or carrying on of the business in India by a non-banking financial company shall not be prejudicial to the public interest or in the interest of the depositors.

(5) The Bank may, after being satisfied that the conditions specified in subsection (4) are fulfilled, grant a certificate of registration subject to such conditions which it may consider fit to impose.

(6) The Bank may cancel a certificate of registration granted to a non-banking financial company under this section if such company–

(i) ceases to carry on the business of a non-banking financial institution in India; or

(ii) has failed to comply with any condition subject to which the certificate of registration had been issued to it; or

(iii) at any time fails to fulfil any of the conditions referred to in clauses (a) to (g) of sub-section (4); or

(iv) fails–

(a) to comply with any direction issued by the Bank under the provisions of this chapter; or

(b) to maintain accounts in accordance with the requirements of any law or any direction or order issued by the Bank under the provisions of this Chapter; or

(c) to submit or offer for inspection its books of account and other relevant documents when so demanded by an inspecting authority of the Bank; or

(v) has been prohibited from accepting deposit by an order made by the Bank under the provisions of this Chapter and such order has been in force for a period of not less than three months:

Provided that before cancelling a certificate of registration on the ground that the non-banking financial company has failed to comply with the provisions of clause (ii) or has failed to fulfil any of the conditions referred to in clause (iii) the Bank, unless it is of the opinion that the delay in cancelling the certificate of registration shall be prejudicial to public interest or the interest of the depositors or the non-banking financial company, shall give an opportunity to such company on such terms as the Bank may specify for taking necessary steps to comply with such provision or fulfillment of such condition;

Provided further that before making any order of cancellation of certificate of registration, such company shall be given a reasonable opportunity of being heard.

(7) A company aggrieved by the order of rejection of application for registration or cancellation of certificate of registration may prefer an appeal, within a period of thirty days from the date on which such order of rejection or cancellation is communicated to it, to the Central Government and the decision of the Central Government where an appeal has been preferred to it, or of the Bank where no appeal has been preferred, shall be final:

Provided that before making any order of rejection of appeal, such company shall be given a reasonable opportunity of being heard.

Explanation.– For the purposes of this section,–

A. "net owned fund" means–

(a) the aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance-sheet of the company after deducting therefrom–

i. accumulated balance of loss;
ii. deferred revenue expenditure; and
iii. other intangible assets; and

(b) further reduced by the amounts representing–

(1) investments of such company in shares of–

i. its subsidiaries;
ii. companies in the same group;
iii. all other non-banking financial companies; and

(2) the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with,–

i. subsidiaries of such company; and
ii. companies in the same group, to the extent such amount exceeds ten per cent of (a) above.

B. “subsidiaries” and “companies in the same group” shall have the same meanings assigned to them in the Companies Act, 1956.

PRODUCTS OFFERED BY NBFCS IN INDIA

- **Funding for commercial vehicles**

The rate of interest for the commercial car loan depends on various factors like customer profiles and location. A commercial vehicle loan can be taken for a variety of commercial vehicles, which may be used at different locations. The commercial vehicle loan is applicable to customers with diverse profiles.

- **Retail financing**

Typical mass-market banking in which individual customers use local branches of larger commercial banks. Services offered include savings and checking accounts, mortgages, personal loans, debit/credit cards and certificates of deposit (CDs).

- **Loan against shares**

A loan against shares enables you to borrow funds against listed securities such as shares, mutual funds, insurance and bonds to meet current financial needs. Loan against shares is the best way to sort financial needs without liquidating assets.

- **Funding of plant and machinery**

It’s a versatile form of financing equipment used by many businesses – from large engineering firms to small parts manufacturers – because it keeps costs down and naturally helps to improve your cashflow position over the long term. Here’s more of the benefits of plant machinery finance:

1. Immediate access to machinery you need
2. Leasing options that suit how your firm trades
3. Hire Purchase options for title ownership after the period
4. Tax-efficient financing
5. Options to upgrade or update
6. Easier budgeting: fixed payments & fixed period
7. Plant machinery finance
8. Engineering machinery finance
9. Finance for machine tools and other equipment

- **Project finance**

Financing of long-term infrastructure, industrial projects and public services based upon a non-recourse or limited recourse financial structure, in which project debt and equity used to finance the project are paid back from the cash flow generated by the project. Project financing is a loan structure that relies primarily on the project's cash flow for repayment, with the project's assets, rights and interests held as secondary security or collateral.

- **Unsecured personal loan**

An unsecured loan is a loan that is issued and supported only by the borrower's creditworthiness, rather than by any type of collateral. An unsecured loan is one that is obtained without the use of property as collateral for the loan.

- **Trade finance**

Trade finance signifies financing for trade, and it concerns both domestic and international trade transactions. A trade transaction requires a seller of goods and services as well as a buyer. Various intermediaries such as banks and financial institutions can facilitate these transactions by financing the trade. Trade finance relates to the process of financing certain activities related to commerce and international trade. Trade finance includes such activities as lending, issuing letters of credit, factoring, export credit and insurance. Companies involved with trade finance include importers and exporters, banks and financiers, insurers and export credit agencies, and other service providers.

- **Venture finance**

It is a type of financing by venture capital. It is private equity capital provided as seed funding to early-stage, high-potential, growth companies (startup companies) or more often it is after the seed funding round as a growth funding round .It is provided in the interest of generating a return on investment through an eventual realization event such as a trade sale of the company.

Module 4 – (a)

MAJOR NBFCs OPERATING IN INDIA

This was the list of Top 10 Non Banking Financial Companies in India 2017 that are well renowned and trusted across the country. India having one of the biggest economies of the world, contributed by the massive financial sector in the country. The NBFC sector has accounted for the 12.5% of the country's gross product. It is safer for both rural and urban regions and ensures the safety for money, quick monetary assistances and promotes the growth of the country.

1. **HDFC Ltd** : It was formed in 1977 and is the largest and most trusted NBFC in the country today. It is a leader in providing housing and business finance in India. With a strong presence in 300 locations across the country, it has offered over Rs 3 trillion in loans. It offers loans in such product segments as home loans, plot loans, home improvements loans, loans against property, etc.

2. **Aditya Birla Finance Ltd. :** Incorporated in 1991, the ISO 9001:2008 NBFC offers the most excellent, customised solutions across a wide range of segments, from corporate finance to commercial mortgage, and from capital markets to structured finance. ABFL is a part of the Aditya Birla Financial Services Group (ABFSG) which offers a wide range of financial solutions, from life insurance to general insurance broking.
3. **LIC Housing Finance Ltd.** : It is among the leading housing finance NBFCs in the country today, and also one of its most trusted ones. It was founded in 1989 and today, it provides loans for repair, renovation, construction and purchase of property in India. Till date, it has granted loans over Rs 1.39 lakh crore in home loans. It has more than 230 marketing cells and offices all over India.

4. **Indiabulls Housing Finance Ltd.** : Indiabulls has twice won the award for the Best Finance Company of the Year and today, is one of the leading NBFC companies in India. It primarily offers home loans and loans against property and is known for customising its existing products to suit customers wherever possible, with low disbursal and approval times.
5. **Reliance Capital.** : Established in the year 1986 by Dhirubhai Ambani, Reliance is one of the top companies that provide financial services in the country. It is under the management of the Anil Ambani Group. The major services provided are Asset Management, Commercial Finance, Broking and Distribution and Insurance are some of the domains in which the company operates. Mutual Fund, Life Insurance, Mortgage, Business Loan and Asset Construction. It has over 11,000 employees across all major Indian cities. The headquarters is located in Mumbai. The total asset of the company is about 1.1 billion dollars.
6. **Mahindra And Mahindra Financial Services Limited (MMFSL)** : Mahindra and Mahindra Financial Services Limited (MMFSL) is one of the country's top rural NBFC. It was established in 1991 and has over 1000 branches in the country. Their services include vehicle loans, home loans, gold loans, corporate loans, working capital loans, etc. Mahindra Insurance Brokers Limited and Mahindra Rural Housing Finance Limited are its two subsidiaries these subsidiaries offer insurance services and housing financial services of premier quality. It has more than 3 million customers.
7. **Power Finance Corporation Limited :** Managed by Mukesh Kumar Goel (Chairman & Managing Director) the Power Finance Corporation Limited provides financial aid to the different ongoing power projects of the company. It is a part of the Navratna Status Company and was established in the year 1986. Projects related to power transmission, Power generation and

distribution are offered financial support by this company.PFC is listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE).

8. **Bajaj Finserv :** Bajaj Finserv founded in the year 2007 is a part of Bajaj Holdings & Investments Limited and is one of the leading financial companies of India. Bajaj Finserv Limited offers its services in the business of lending, wealth advisory and insurance. Personal Loan, Doctor Loan, Gold Loan, Home Loan and Business Loan are some of the products of the company. It has about 20,000 employees and is established in more than 1400 locations in the country.
9. **L&T Finance** : Founded in 1938 by Danish engineers, L & T Finance Limited offers financial services for various sectors like agriculture, industry, trade, etc. Its headquarters is located n Mumbai and has been awarded as the company of the year in the 2010 Economic Times awards. Some of their services include help related to Personal Vehicle Loans, Commercial Vehicle Loans, Rural Loans and Corporate Loans are some of the products of the company. L & T Finance has catered to 10 lakh people.
10. **Shriram Transport Finance Company Limited** : This company offers financial services in matters related to transport. It was founded in the year 1979 by Ramamurthy Thyagarajan, AVS Raja and T. Jayaraman. Their headquarters is situated in Chennai, Tamil Nadu. Its other specializations include services in like mutual funds, general insurance, stock broking, and also finance for Heavy Duty Truck, Light Duty Truck, Passenger Vehicle, Farm Equipment, Mini Truck, Construction Vehicle, etc. It is one of the Top 10 Non Banking Financial Companies in India 2017.

Rising Trends in NBFC Sector in India

Non-banking financial companies ("NBFC") have undergone significant transformation over the past few years. Liberalisation of the legal regime, increasing digitisation and rising financial inclusion have given a boost to innovation, growth and investment in the financial sector.

- **Regulatory changes**

Last year, the government liberalised the financial services sector by permitting 100% foreign direct investment in the financial sector under the automatic route, subject to the relevant entity being regulated by the Reserve Bank of India ("RBI") or other financial sector regulators. Further, the benefit of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 was extended to 196 NBFCs allowing such NBFCs to enforce security interests on assets charged to them, without having to resort to either judicial or arbitral authorities. Now, the government is working towards harmonising the regulations applicable to various categories of NBFCs to facilitate ease-of-doing business in this sector. The government is also taking actions towards a technological revolution in this sector by implementing an information technology framework and promoting FinTech activities.

- **Operational innovation and growth**

With the rising innovation and growth in the sector, newer business models of NBFCs such as 'account aggregators' and 'peer to peer lending platforms' ("P2P Lending") are catching pace. To clarify, account aggregator is a form of NBFC engaged in collecting and providing information on a customer's financial assets, in a consolidated, organised and retrievable manner.

Further, P2P Lending is a form of crowd-funding which uses an online platform to match lenders with borrowers to provide unsecured loans. RBI notified P2P Lending platforms as NBFCs on 24 August 2017 and recently issued the Master Directions to regulate the P2P Lending platforms on 4 October 2017.

The NBFC sector is also seeing a surge of newer structured products like Market and Credit Linked Debentures wherein the principal investment of the debenture holder is protected and the interest payment, to be made at maturity, is linked to the performance of an underlying Index or a stock.

- **Varied investment strategies**

Over the years, NBFC sector has witnessed diverse investment structures ranging from strategic investments, private equity investments to debt funding through NBFC route (including private equity funds establishing their NBFC arms). Strategic investments provide financial and operating synergy and help NBFCs tap new markets and provide expertise in operations. However, private equity investments provide capital infusion which can be utilised for expansion purposes, facilitate technology upgradation and also help in enhancing corporate governance of NBFCs. Debt funding through NBFCs is another investment strategy whereby foreign investors set up or acquire NBFCs in India and use such NBFCs to further lend or invest in Indian companies through structured instruments such as non-convertible debentures (which have an advantage of protected downside and equity upside by way of redemption premium or coupons). While, a number of investments have been structured in such a manner, there are divergent views in the market as to whether such investments through structured instruments could be subject to any issues from the foreign direct investment policy perspective.

- **Increased market activity with more registrations, approvals and listings**

In 2016, RBI introduced a fast track registration process and two categories of applications depending on acceptance of public funds and customer interface. This fast track process increased activity in the sector in the form of registration of new NBFCs. Additionally, the number of approvals granted for foreign investment in investing companies and the number of NBFC listings with the stock exchanges have also increased substantially. The sector has also witnessed a large number of entrepreneurial initiatives and successes, mostly aiming at mid to bottom-of-the-pyramid customers.

- **Sector to look out for**

The government policy of demonetisation acted as a deterrent for the unorganised sector and led to compulsive financial inclusion. The regulatory changes aimed towards promoting foreign investment also provided a boost to the financial sector. This sector has evolved significantly in the past few years and the growth of financial inclusion is expected to be driven further with higher penetration into parts of the economy where public-sector banks are unable to penetrate.

LEGAL FRAMEWORKOF NBFC

What is NBFC?

From the sections 45-I (a), (c) & (f).

- Non –banking financial Company means, which is engaged in- financing
- acquisition of shares, stocks, bonds, debentures or securities - letting or delivering of any goods to a hirer
- carrying on of any class of insurance business
- managing, conducting or supervising, as a foreman, agent or in any other capacity, of chits or kuries
- collecting for any purpose or under any scheme or arrangement, monies in lump sum or otherwise, by way of subscriptions or by sale of units or in any other manner and awarding prizes or gifts, whether in cash or kind or disbursing monies in any other way, to persons from whom monies are collected or to any other person.

But doesn't include-

Which carries as its principal business

- Agricultural operations
- Industrial activity
- Purchase or sale of any goods (other than securities) or the providing of any services
- Purchase, construction or sale of immovable property, so, however, that no portion of income of the institution is derived from the financing of purchases, constructions or sales of immovable property by other persons

Requirement of Registration and Net Owned Fund

Section 45-IA of RBI Act, 1934

No NBFC shall commence or carry on the business of non- banking financial institution without-

• Obtaining a certificate of registration and

• Having net owned fund

Notification No. DNBS. 132/CGM(VSNM)-99, DATED 20- 4-1999

Net owned fund to be 200 lakhs rupees for a NBFC which commences the business of a non-banking financial institution on or after 21st April, 1999 and 25 lakhs rupees for whose application for certificate of registration under section 45-IA is submitted to RBI on or before 20th April, 1999.

Commencement of Business by NBFC

RBI2013-14/46DNBS(PD)CC

No./344.03.02.001/2013-14

NBFC , which is in the Receipt of a COR from the Bank must necessarily commence NBFCs Business within six months of obtaining COR. If the Business is not commenced by the company within a period of six months , the COR shall stand withdrawn automatically.

Computation of Net Owned Fund

(a) The aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance sheet of the Company after deducting there from i . Accumulated balances of loss

ii. Deferred revenue expenditure

iii. Other intangible assets and

(b) further reduced by the amounts representing

(1). Investment of such company in shares of

i. Its subsidiaries

ii. Companies in same group

iii. All other Non-Banking Financial Companies and

(2) The book value of debentures, bonds, outstanding loans and advances (including hire purchase and lease finance) made to, and deposit with

i. Subsidiaries of such company and

ii. Companies in same group To the extent such amount exceeds ten percent of (a) above

Principal Business Criteria

Press Release 99/1269 dated April 8, 1999

A company is treated as NBFC if its financial assets are more than 50% of its total assets (net of intangible assets) and income from these financial assets is more than 50% of the gross income. Note :-

RBI/2011-12/446

DNBS (PD) CC.No.259/.03.02.59/2011-12

Investments in fixed deposits can not be treated as financial assets and receipt of Interest Income from fixed deposits with bank can not be treated as Income from financial assets.

Exemption From The Provisions Of RBI Act, 1934

RBI/2013-14/38

DNBS.PD.CC.No.336/03.02.004/2013-1

Exemption has been provided to following :-

i. Housing Finance Institutions

ii. Merchant Banking Company

iii. Micro Finance Companies

iv. Mutual Benefit Companies

v. Government Companies

vi. Venture Capital Fund Companies

vii. Insurance/Stock Exchange/Stock Broker/Sub-Broker

viii. Others - Nidhi Companies, Chit Companies, Securitisation & Reconstruction Companies, Mortgage Guarantee Companies & Core Investment Companies

Exemption To Venture Capital Fund

Provided VCF holding certificate of Registration of SEBI and not holding or accepting public deposit.

Exemption To Micro Finance Companies

Provided they are engaged in micro finance activities, providing credit not exceeding Rs. 50,000 for a business enterprise and Rs. 1,25,000 for meeting the cost of a dwelling unit to any poor person for enabling him to raise his level of Income and standard of living and Licensed under section 25 of the Companies Act, 1956 And Not accepting public deposits

Exemption To Merchant Bankers

- Provided it is registered with SEBI and carrying on the business of merchant banker in accordance with SEBI Merchant Banking (Rules), 1992.
- Acquires securities only as a part of its merchant banking business
- Doesn't carry on any other financial activity referred to in section 45I(c) of RBI Act, 1934
- Doesn't accept or hold Public deposits

Reserve Fund

Section 45-IC

Every non-banking financial company shall create a reserve fund and transfer therein a sum not less than twenty percent of its net profit every year as disclosed in the profit & loss account & before any dividend is declared.

No appropriation of any sum from Reserve fund shall be made except for the purpose as may be specified and every such appropriation shall be reported within 21 days from the date of such withdrawal which for sufficient cause may be extended by Bank.

Registration of NBFC

Application for a Certificate of Registration should be submitted to "The General Manager/Deputy General Manager/ Department of Non-Banking Supervision, Reserve Bank of India, Regional Office."

Documents required to be enclosed to the application form-

1. Identification Particulars

2. Statement on prudential norms

3. Information about the management

4. Certified copies of Certificate of Incorporation and Certificate of Commencement of Business.

5. A Board Resolution specifically approving the submission of the application and its contents.

6. A copy each of the Profit & Loss Account & Audited Balance Sheet for the last 3 years or for such shorter period as are available (for Companies already in existence)

7. Certified copies of up-to-date Memorandum and Articles of Association of the Company.

8. Business plan of the Company for the next three years giving details of its

(a) thrust of business;

(b) market segment; and

(c) projection of investments and income.

9. A company which is incorporated before January 9, 1997 and has net owned fund of less than 25 lakhs as on the date of application, may also furnish a time- bound program as how it proposes to attain the minimum net owned fund of Rs. 25 lakhs

Cancellation of Certificate of Registration & Appeal against thereof

The Reserve Bank is empowered to cancel the certificate of registration issued to any NBFC for failure on the part of NBFC to fulfil conditions as laid down under section 45-IA of the RBI Act, 1934.

A company, aggrieved by the Reserve Bank's order of rejection of application or cancellation of certificate of registration may prefer an appeal to Central Government within a period of 30 days.

Module 4 – (b)

Procedure of application to the RBI for NBFC registration-section 45-1A of the RBI act,1934 company act section 3

45-IA. Requirement of registration and net owned fund.

(1) Notwithstanding anything contained in this Chapter or in any other law for the time being in force, no non-banking financial company shall commence or carry on the business of a non-banking financial institution without–

(a) obtaining a certificate of registration issued under this Chapter; and

(b) having the net owned fund of twenty-five lakh rupees or such other amount, not exceeding two hundred lakh rupees, as the Bank may, by notification in the Official Gazette, specify.

(2) Every non-banking financial company shall make an application for registration to the Bank in such form as the Bank may specify:

Provided that a non-banking financial company in existence on the commencement of the Reserve Bank of India (Amendment) Act, 1997 shall make an application for registration to the Bank before the expiry of six months from such commencement and notwithstanding anything contained in sub-section (1) may continue to carry on the business of a non-banking financial institution until a certificate of registration is issued to it or rejection of application for registration is communicated to it.

(3) Notwithstanding anything contained in sub-section (1), a non-banking financial company in existence on the commencement of the Reserve Bank of India (Amendment) Act, 1997 and having a net owned fund of less than twenty-five lakh rupees may, for the purpose of enabling such company to fulfil the requirement of

the net owned fund, continue to carry on the business of a non-banking financial institution–

(i) for a period of three years from such commencement; or

(ii) for such further period as the Bank may, after recording the reasons in writing for so doing, extend, subject to the condition that such company shall, within three months of fulfilling the requirement of the net owned fund, inform the Bank about such fulfilment:

Provided that the period allowed to continue business under this subsection shall in no case exceed six years in the aggregate.

(4) The Bank may, for the purpose of considering the application for registration, require to be satisfied by an inspection of the books of the nonbanking financial company or otherwise that the following conditions are fulfilled:–

(a) that the non-banking financial company is or shall be in a position to pay its present or future depositors in full as and when their claims accrue;

(b) that the affairs of the non-banking financial company are not being or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors;

(c) that the general character of the management or the proposed management of the non-banking financial company shall not be prejudicial to the public interest or the interest of its depositors;

(d) that the non-banking financial company has adequate capital structure and earning prospects;

(e) that the public interest shall be served by the grant of certificate of registration to the non-banking financial company to commence or to carry on the business in India;

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

(g) any other condition, fulfilment of which in the opinion of the Bank, shall be necessary to ensure that the commencement of or carrying on of the business in India by a non-banking financial company shall not be prejudicial to the public interest or in the interest of the depositors.

(5) The Bank may, after being satisfied that the conditions specified in subsection(4) are fulfilled, grant a certificate of registration subject to such conditions which it may consider fit to impose.

(6) The Bank may cancel a certificate of registration granted to a non-banking financial company under this section if such company–

(i) ceases to carry on the business of a non-banking financial institution in

India; or

(ii) has failed to comply with any condition subject to which the certificate

of registration had been issued to it; or

(iii) at any time fails to fulfil any of the conditions referred to in clauses

(a) to (g) of sub-section (4); or

(iv) fails–

(a) to comply with any direction issued by the Bank under the provisions of this chapter; or

(b) to maintain accounts in accordance with the requirements of any law or any direction or order issued by the Bank under the provisions of this Chapter; or

(c) to submit or offer for inspection its books of account and other relevant documents when so demanded by an inspecting authority of the Bank; or

(v) has been prohibited from accepting deposit by an order made by the Bank under the provisions of this Chapter and such order has been in force for a period of not less than three months:

Provided that before cancelling a certificate of registration on the ground that the non-banking financial company has failed to comply with the provisions of clause (ii) or has failed to fulfil any of the conditions referred to in clause (iii) the Bank, unless it is of the opinion that the delay in cancelling the certificate of registration shall be prejudicial to public interest or the interest of the depositors or the non-banking financial company, shall give an opportunity to such company on such terms as the Bank may specify for taking necessary steps to comply with such provision or fulfillment of such condition;

Provided further that before making any order of cancellation of certificate of registration, such company shall be given a reasonable opportunity of being heard.

(7) A company aggrieved by the order of rejection of application for

registration or cancellation of certificate of registration may prefer an appeal, within a period of thirty days from the date on which such order of rejection or cancellation is communicated to it, to the Central Government and the decision of the Central

Government where an appeal has been preferred to it, or of the Bank where no appeal has been preferred, shall be final:

Provided that before making any order of rejection of appeal, such company shall be given a reasonable opportunity of being heard.

Explanation.– For the purposes of this section,–

(I) “net owned fund” means–

(a) the aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance-sheet of the company after deducting therefrom–

(i) accumulated balance of loss;

(ii) deferred revenue expenditure; and

(iii) other intangible assets; and

(b) further reduced by the amounts representing–

(1) investments of such company in shares of–

(i) its subsidiaries;

(ii) companies in the same group;

(iii) all other non-banking financial companies; and

(2) the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with,–

(i) subsidiaries of such company; and

(ii) companies in the same group,

to the extent such amount exceeds ten per cent of (a) above.

(II) “subsidiaries” and “companies in the same group” shall have the same meanings assigned to them in the Companies Act, 1956.

Sec 3. Formation of company.— (1) A company may be formed for any lawful purpose by—

(a) seven or more persons, where the company to be formed is to be a public company;

(b) two or more persons, where the company to be formed is to be a private company; or

(c) one person, where the company to be formed is to be One Person Company that is to say, a

private company, by subscribing their names or his name to a memorandum and complying with the requirements of this

Act in respect of registration:

Provided that the memorandum of One Person Company shall indicate the name of the other person,

with his prior written consent in the prescribed form, who shall, in the event of the subscriber‘s death or

his incapacity to contract become the member of the company and the written consent of such person

shall also be filed with the Registrar at the time of incorporation of the One Person Company along with its memorandum and articles:

Provided further that such other person may withdraw his consent in such manner as may be prescribed:

Provided also that the member of One Person Company may at any time change the name of such other person by giving notice in such manner as may be prescribed:

Provided also that it shall be the duty of the member of One Person Company to intimate the company the change, if any, in the name of the other person nominated by him by indicating in the memorandum or otherwise within such time and in such manner as may be prescribed, and the company shall intimate the Registrar any such change within such time and in such manner as may be prescribed:

Provided also that any such change in the name of the person shall not be deemed to be an alteration

of the memorandum.

(2) A company formed under sub-section (1) may be either—

(a) a company limited by shares; or

(b) a company limited by guarantee; or

(c) an unlimited company.

Module 5a

FINANCIAL INCLUSION AND MICROFINANCE OBJECTIVES

FINANCIAL INCLUSION

A. Definition of Financial Inclusion:

"Dr. C. Rangarajan Committee (2008): Financial inclusion is the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low-income groups at an affordable cost."

B. Concept of Financial Inclusion:

Financial inclusion is generally defined in terms of financial exclusion. In India most of the population belongs to lower income group, but the facilities which can be availed be it financial services or any other services generally targets the few rich people, thereby the low income group gets neglected. This is the kind of exclusion which needs to be faced by favouring the concept of financial inclusion.

The main problem faced by the lower income group people is the non accessibility of banking and other financial services, which causes hindrance in their social and economic development. These financial products include insurance; credit etc.The great tragedy lies in the fact that sometimes even though there are certain financial services which are specially designed to meet the needs of these low income group people, these people are not aware of it due to illiteracy or any other reason. Thus lack of awareness also leads to the financial exclusion of these people.

Recently, Comprehensive Financial Inclusion Plan (CFIP) has been floated by Prime Minister Narendra Modi, by the name of Pradhan Mantri Jan-Dhan Yojna. In this scheme technology adaptation will play an important role the reason being that it is impossible to set up branches in all the unbanked areas, instead electronic account can help people easy access as well as the goal of each and every person having at least one bank account can easily be achieved by the advent of technology. Over the years many developments have been made in the field of financial inclusion still much remains to be done because still out of the 24.67crore households in the country, 10.19 crore do not have access to banking services, moreover in rural areas 44 Micro finance and in the urban areas 33 Micro finance do not have a bank account. This scheme will not only take account of the financial exclusion faced in the rural areas alone rather it will also focus on the lower income group people in urban areas who are in need of financial services but have been neglected till now.

Objectives of micro finance

A relatively new branch of financial services, microfinance aims to promote self-sufficiency and economic development among people who don't have access to the traditional financial sector. They do this primarily by extending small loans without the strict requirements of traditional lenders. Recipients are usually the poor and "unbanked," but they also include people who are not poor but who lack the credit standing to borrow money to start or grow a business.

- **Access to Capital**

When people can't tap into the mainstream financial services system for capital to start a business, they're forced to turn to "informal" sources -- relatives, friends and even black-market lenders, or "loan sharks." Such sources are often unreliable, and they can also be expensive, charging potentially ruinous interest rates that can strangle a new business before it can get established. By lending money to such people, microfinance institutions provide access to capital.

- **Entrepreneurship and Self-Sufficiency**

Underprivileged people may have potentially profitable business ideas, but they cannot put them into action because they lack sufficient capital for start-up costs. "Microcredit" loans give clients just enough money to get their idea off the ground so they can begin turning a profit. They can then pay off their micro loan and continue to gain income from their venture indefinitely.

- **Improved Standards of Living**

Microcredit ultimately aims to give impoverished people enough financial stability to move from simply surviving to accruing savings. This gives them a certain amount of protection from sudden financial problems. Savings also allow for educational investment, improved nutrition, better living conditions and reduced illness. Microinsurance, another segment of the microfinance sector, provides people the ability to pay for health care when needed, so they can receive treatment for health conditions before they become grave and more costly to treat.

- **Women's Economic Advancement**

Women make up a large proportion of microfinance beneficiaries. Traditionally, women (especially those in underdeveloped countries) have been unable to readily participate in economic activity. Microfinance provides women with the financial backing they need to start business ventures and actively participate in the economy. The aim is to improve their status and make them more active in decision-making, thus encouraging gender equality. According to the international Consultative Group to Assist the Poor, microfinance institutions have even reported a decline in violence against women in areas targeted by microfinance programs.

- **Trickle-Down Benefits**

Microfinance lenders hope to improve not just the lives of their direct clients, but also the health of their clients' communities. New business ventures can provide jobs, thereby increasing income among community members and improving their overall well-being.

MICROFINANCE AS A DEVELOPMENT TOOL

People living in poverty – like everyone else need access to a diverse range of financial services, including loans, saving services, insurance & money transfers. Access to financial services can help enable the poor to increase income & smooth consumption flows, & thus expend their asset base & reduce their vulnerability to the external shocks that are a part of their daily existence. The availability of financial services acts as a buffer against sudden emergencies, business risk & seasonal slums that can push a family into destitution. More & better financial services specifically geared towards low income groups can help poor households to move from every day survival to planning for the future, investing in better nutrition, improver living condition & children‘s health & education.

Microfinance has the potential to benefit poor people both indirectly, through increased growth, & directly as they gain access to needed services. Impact studies show that in money cases,microfinance reduced poverty through increasing income levels. Studies also show that microfinance improves poor people‘s lives by contributing to improved healthcare, children‘s education & nutrition & women‘s empowerment.

In particular, the ability to borrow, save & earn income reduced economic vulnerability for women & their households, increased financial & food security can bring a new confidence & hope which often translates to a greater sense of empowerment to a person.

Nonetheless, microfinance is not a panacea. Even the most innovative & participative programmes can lead to unwanted negative impacts.

Microfinance has in many cases been shown to benefit the better Off poor more than the truly destitute. Many early impact studies on microfinance showed increasing income levels, but more recent & better designed studies have shown that in many cases the impact varies per income group. In most cases the better off benefit more from micro credit, due to their higher skills level, better market contacts & higher initial resource base. Lower income groups may be more risk-averse & benefit more from saving & micro insurance.

Many microfinance & micro credit programmed target women in particular, largely due to their (generally) higher repayment rates, but in many cases this is mixed blessing. If a programmed excludes men, particularly in areas where access to financial services is limited, the man may require his wife to get the loan for him. Others have argued that exclusive access for women actually increases her bargaining power within the household. While inspiring examples abound of women taking loans& then using the income from their business to provide employment to others, feed their children‘s send them to school, & become empowered members of their community & their household, many more examples exist of vivacious circles of debt, family violence & increased workloads.

Microfinance – the Indian Experience

Microfinance is the provision of loans and other financial services to the poor. The microfinance has evolved due to the efforts of committed individuals and financial agencies to promote self-employment and contribute to poverty alleviation and provision of social security. India has been able to develop its own model of microfinance organizations in the form of savings and credit groups known as the Self Help Group (SHGs), which are bank-linked.Microfinance is a concept that is helping the poor to avail of and create opportunities for economic growth. In India, microfinance has filled the efforts of rural development, women empowerment and wealth generation by providing small scale savings, credit, insurance and other financial services to poor and low income households. Microfinance thus serves as a means to empower the poor and provides a valuable tool to help the economic development process.Theoretically, microfinance also known as microcredit or micro lending means making provision for smaller working capital loans to the self-employed or self-employment seeking poor.

The concept of microfinance is not new in India. Traditionally, people have saved with and taken small loans from individuals and groups within the context of self-help to start businesses or farming ventures. Majority of poor are excluded from financial services. Micro finance is a programme to support the poor rural people to pay its debt and maintain social and economic status in the villages. Micro-finance is an important tool for improving the standard of living of poor. Inspite of many organizations of micro finance, micro finance is not sufficient in India. The study explores some suggestions to make micro finance more effective. The potential for growing micro finance institutions in India is very high. Microfinance market in India is expected to grow rapidly, supported by government of India's initiatives to achieve greater financial inclusion, and growth in the country's unorganized but priority sector. Microfinance has evolved rapidly into a global movement dedicated to providing access to a range of financial services to poor and near-poor households. The organizations that provide these services, known as microfinance institutions (MFIs) may operate as formal micro banks, non-bank financial institutions, non-governmental organizations, or community-based financial institutions. These providers offer a range of financial services from small business loans to savings accounts, money transfers, insurance, and consumer loans. Growth of the microfinance industry, however, the microfinance is important as a minimum condition for achieving these social missions. Major Cross-section can have benefit if this sector will grow in its fastest pace. The microfinance industry being very small in terms of value added to the Indian financial sector. It examines the experience, of India, which has one of the largest microfinance sectors in the world. Globally, over a billion poor people are still without access to formal financial services.

The Important Features of Microfinance are

1. Microfinance is a tool for the empowerment of poor women;
2. Loans under microfinance programmes are very small;
3. Microfinance targets the poor rural and urban households;
4. Credit under microfinance follows thrift i.e. mobilize savings and lend the same;
5. Low transaction cost due to group lendings;
6. Transparencies in operation;
7. Short repayment period;
8. Simple procedure for reviewing, processing and approving loan applications and delivery credit;
9. Chances of misutilization are rare and there is assured repayment;
10. Peer pressure act as the collateral security required for loans;
11. Need based loan disbursement.

The profile of microfinance in India at present can be traced out in terms of poverty. It is estimated that 350 million people live below poverty line. The following are some components of microfinance :-

(a) This translates to approximately 75 million households.

(b) Annual credit demand by the poor in the country is estimated to be about Rs. 60,000 crores.

c) A cumulative disbursement under microfinance programmes is only about Rs. 5000 crores

d) Total outstanding of all microfinance initiative in India estimated to be Rs. 1600 crores.

(e) Only about 5% of rural poor have access to microfinance.

(f) Though a cumulative of about 20 million families have accepted accessed.

(g) While 10% lending to weaker sections is required for commercial banks; they neither have the network for lending and supervision on a larger scale or confidence to offer term loan to big microfinance institutions.

(h) The non poor comprise of 29% of the outreach

Evolution and character of Microfinance in India

The evolution of Indian Microfinance sector can be broadly divided into four distinct phases:

Phase 1: The Cooperative Movement (1900-1960)

During this phase, credit cooperatives were vehicles to extend subsidized credit to villages under government sponsorship.

Phase 2: Subsidized Social Banking (1960s - 1990)

With failure of cooperatives, the government focused on measures such as nationalization of Banks, expansion of rural branch networks, establishment of Regional Rural Banks (RRBs) and the setting up of apex institutions such as the National Bank for Agriculture and Rural Development (NABARD) and the Small Scale Industries Development Bank of India (SIDBI), including initiation of a government sponsored Integrated Rural Development Programme (IRDP). While these steps led to reaching a large population, the period was characterized by large-scale misuse of credit, creating a negative perception about the credibility of micro borrowers among bankers, thus further hindering access to banking services for the low-income people.

Phase 3: SHG-Bank Linkage Program and Growth of NGO-MFIs (1990 - 2000)

The failure of subsidized social banking triggered a paradigm shift in delivery of rural credit with NABARD initiating the Self Help Group (SHG) Bank Linkage Programme (SBLP), aiming to link informal women's groups to formal banks. The program helped increase banking system outreach to otherwise unreached people and initiate a change in the bank's outlook towards low-income families from 'beneficiaries' to 'customers'. This period was thus marked by the extension of credit at market rates.

The model generated a lot of interest among newly emerging Microfinance Institutions (MFIs), largely of non-profit origin, to collaborate with NABARD under this program. The macroeconomic crisis in the early 1990s that led to introduction of the Economic Reforms of 1991 resulted in greater autonomy to the financial sector. This also led to emergence of new generation private sector banks that would become important players in the microfinance sector a decade later.

Phase 4: Commercialization of Microfinance: The First Decade of the New Millennium

Post reforms, rural markets emerged as the new growth drivers for MFIs and banks, the latter taking interest in the sector not only as part of their corporate social responsibility but also as a new business line. On the demand side, NGO-MFIs increasingly began transforming themselves into more regulatedlegal entities such as Non-Banking Finance Companies (NBFCs) to attract commercial investment. The microfinance sector as it exists today essentially consists of two predominant delivery models the SBLP and MFIs. Four out of five microfinance clients in India are women.

History of Micro Finance in India

Modern types ofmicrofinance were started its development since later half of 20th century especiallyafter 1970. Our country also witnessed the development of such like institutions inthe same period.Government's initiative to reduce poverty by improving access to financialservices to poor started since independence.

1904: Legal framework for establishing the co-operative movement set up in 1904.

1934: Reserve Bank of India act 1934, provided for the establishment of the Agricultural credit development.

1969: Nationalization of Banks.

1974: Establishment of Self-Employed Women's Association (SEWA) in Gujarat.

1975: On September 26 Rural Bank Ordinance was passed.

1975: On October 2 Prathama Bank came into existence.

1976: ordinance was replaced by Regional Rural Bank Act.

1982: On july 12 NABARD was established on the recommendations of Shivaraman Committee, by an act of parliament to implement the National Bank for Agriculture and Rural Development Act 1981.

1990: On April 2 SIDBI was established through Small Industries Development Bank of India Act 1989.

1992: NABARD launched SHGs Bank Linkage program.

1999: SIDBI created microcredit to create a national network of strong, viable and sustainable microfinance institutions from the informal and formal financial sector to provide microfinance services to the poor, especially women.

2006: NABARD launched the Micro Enterprise Development Program for skill development.

March 2006: Comprehensive guidelines by RBI on loan securitization.

July 2006: RBI master circular allows NGOs involved in microfinance to access External Commercial Borrowings (ECB) up to USD 5) million (INR 20.25 crores during a year.

March 2007: Finance Minister introduces the "Microfinance Sector Development and Regulation Bill 2007" in Loksabha.

Microfinance Delivery Methodologies and models

Operational Structure Of Group And Individual Methodologies And Models

Individual and group methodologies require different structures of operational and financial organization. It is important for the most appropriate structure to be selected based on organizational goals, profitability objectives, and risk tolerance.

Individual lending and group lending have different cost structures. Individual lending requires careful analysis on behalf of the lending institution prior to fund disbursement. Evaluating the loan proposal and defining the terms for each particular client, which may take several weeks, is costly to the lending body. In contrast, group lending is less time consuming, and hence less costly, prior to fund disbursement. However, managing groups requires additional and greater costs after closing.

Operational costs for group lending tend to be higher than those of individual lending, largely due to the additional time required for managing groups. In addition, because the bank holds no collateral, group lending is considered riskier than individual lending. High operational costs to the bank combined with relatively high risk require high revenues if the lending institution is to be sustainable. As a result, group loans are usually more expensive and have higher rates of interest than individual loans.

Approaches to Group Lending

Unlike individual lending programs, which tend to generally follow the same approach, there is wide methodological variation among group lending programs

Solidarity Group vs. Community-Based Organization Approaches

Group lending programs can be subdivided into Solidarity Group approaches and Community-Based Organization (CBO) approaches. The distinction between the Solidarity Group approach and CBO approach to group lending has to do with the desired future relationship between the lending body and the borrower group. CBO approaches have as a primary goal the eventual independence of the borrower group from the lending body. To this end, the lending body encourages the development of the internal financial management capacity of the group, so that the group can act as its own mini-bank. Solidarity Groups are those programs that do not anticipate the eventual graduation of the borrower group from the lending institution. Participants are considered long-term "clients" of the program.

➢ Solidarity Group Models

- **Grameen Bank Model**

One of the most famous examples of the solidarity group model is the Grameen Bank. The Grameen Bank, founded by Muhammad Yunus in Bangladesh in 1976, was the first microlending program to use a solidarity group approach. The bank has grown very rapidly. In 1992, it lent to 2 million people at real interest rates of around 12 to 16 percent. Their repayment rate is high, around 97 to 98 percent. The bank even shows a profit, though it would not do so without the low-interest loans and grants it has received. The following is a summary of Grameen methodology:

First, staff identify a potential village and conduct a one or two week training course in the village to orient future clients to the philosophy, rules and procedures of the program. Then, groups of five unrelated, self-selected prospective borrowers are formed. Between six and eight of these five member groups are come together to form a village "center", groups of which in turn form Regional Branch Offices. Branch workers work with a large number of clients (usually 200-300) and do not evaluate individual loans. Instead, branch workers leave clients or members to assume responsibility for much of the management of financial services. In the Grameen model, groups of borrowers do more than just guarantee loan repayment—they become a part of the institutional structure of the bank. Hence, the institution is built "from the ground up.

New groups of potential borrowers meet and save for a minimum of 4 weeks before any loans are granted. The group appoints a group leader (whose position rotates among all group members) and group members determine the rotation of access to credit. Two members of the group receive the first loans, which are generally under $100. After timely repayment for four to six weeks, two additional members receive loans. After another month, the fifth member (usually the group leader) receives his or her loan. The responsibility for loan repayment is the legal obligation of all five group members, regardless of which group member received the loan. If any group member defaults on a loan, the other four members must cover the loan. None of the members will receive further loans until the delinquent loan is repaid. In this sense, a sense of collective responsibility serves as collateral on the loan. When groups have established a good repayment history, loan amounts are gradually increased, but normally do not exceed $300.

In addition to repayment requirements, the Grameen Bank incorporated strong social requirements into its program. Known as the “Sixteen Decisions” these requirements state that borrowers must educate their children; maintain their own health and the health of their families (by boiling all drinking water, maintaining a clean environment, using pit-latrienes, and exercising); commit to growing vegetables all year round; not participate in the dowry system. For the full text of the Sixteen Decisions, see Appendix A.

The Grameen model provides credit to the very poor in rural areas without requiring any collateral. To this clientele, who historically have very little access to credit and almost no access to credit at low interest rates, microloans have proven an effective weapon in the fight against poverty. The Grameen Bank has received worldwide attention for this model. More than 4,000 people from some 100 countries have gone through Grameen's training and exposure programs over the last decade. Many of those visitors have returned to their countries and replicated the Grameen Bank model-- a total of 223 Grameen replication programs in 58 countries. Through funding sources such as the International Fund for Agricultural Development and the United Nations Children's Fund among others, the Grameen model of microfinance has been able to reach several hundred thousand poor borrowers around the world.

The Grameen model works best in densely populated rural areas with a static population. Clients are usually women, and loans are usually used for agriculture and retail.

- **Latin American Solidarity Group Model**

In the early 1980's, loan programs in Latin America using individual methodologies considered the success of the Grameen experience and looked for ways in which certain aspects of the Grameen model could be incorporated into their existing programs. The result was the Latin American Solidarity Group model. There are two main differences between the Latin American model and the Grameen model.

First, the Latin American solidarity group model chose to retain loan approval and administration, using the already-existing operational systems developed for individual lending. For example, credit officers perform an analysis of each client's loan request (though this analysis is significantly less extensive than in the case of an individual loan) and visit all group members at their place of business prior to fund disbursement. Group formation is simply a loan guarantee mechanism—groups do not become a part of the institutional structure of the bank.

A second difference is that Latin American solidarity groups are much more focused on the provision of credit than the more socially-oriented aspects of the Grameen model. The Latin American methodology is a minimalist approach, that is, institutions that follow this model often offer only credit services.[1]

An interesting example of solidarity group model is BancoSol, located in Bolivia. It is a chartered bank, subject to the supervision of SIB, the Bolivian bank regulatory agency. It makes uncollateralized loans for periods of 12 to 24 weeks with frequent repayment terms (one or two weeks). Loans are made to solidarity groups of four to ten members and are apportioned among group members. Loans from BancoSol are usually made to provide working capital for small-scale business activities. Most borrowers are market vendors, though half of the portfolio is lent to small-scale producers like shoemakers, bakers, and tailors.[2]

Like the Grameen bank, BancoSol has experienced rapid growth. In 1996, BancoSol lent to about 75,000 people, roughly one-third of the people who use the Bolivian banking sector. In 1996, BancoSol had a loan portfolio of $47.5 million. It also earned $1.1 million on revenues of $13 million.[3] The BancoSol model and the Grameen model have two main similar features. Firstly, group members are jointly liable for each other's debts. Secondly, the majority (77 percent for BancoSol) of clients are women. Unlike the Grameen Bank, most of the borrowers of BancoSol are located in urban areas.

- **Community-Based Organization (CBO) Approaches**

Models of group lending which have as a primary goal the development of the internal financial management capacity of the group are characterized as CBO models. In contrast to Solidarity Group approach, which does not anticipate the eventual graduation of borrower groups from the lending institution, CBO approaches aim to develop a mini-bank, independent of the lending institution, owned and managed entirely by the poor. Microlending models using the CBO approach can be divided into two subgroups: Community-Managed Loan Funds (CMLF) or Saving and Loan Associations (SLA). The distinction between CMLFs and SLAs is

- CMLFs receive initial funding from outside the organization (in the form of a loan or grant). There are two main approaches to community-managed loan funds—Village Banking and Revolving Loan Funds.
- SLAs generate all funds internally (through member savings or retained interest) and receive no external funding

Community Managed Loan Funds (CMLFs)

- **Village Banking**

Village Banking is probably the most practiced kind of Community-Managed Loan Fund.[4] The Village Banking methodology was developed by the Foundation for International Community Assistance (FINCA), a U.S. based nonprofit organization that specializes in rural credit. Programs using this methodology have been widely replicated in different parts of the world by other NGOs. This approach has been successful at reaching poor segments of the population in rural areas.

A Village Bank is initially financed through loans provided by a lending institution. Over time, member savings, share capital and accumulated interest are expected to grow large enough so that no external funding will be necessary. In general, the objective is for each Village Bank to be administratively and financially autonomous by the end of three years, at maximum. Savings mobilization is an integral component of the Village Banking methodology. Savings is more central to the Village Bank model than to either the Grameen Bank model or the Latin American Solidarity Group model. Village Bank members are required to save prior to receiving a loan and to continue saving during the loan cycle.[5]

Implementation of a Village Bank program generally follows the following course:

1. Staff from the NGO or lending institution research and visit potential zones for Bank development. Once a zone is considered eligible, staff present the methodology to local leaders and interested members of the community. If individuals decide to form a lending group, staff train the group in Village Bank practices and work with the self-selected and self-screened group to form and train a management committee. A Village Bank usually has between 20 and 50 members, often women.
2. Individual bank members negotiate their initial loan amount (usually under $50) and terms with the group, and each request is approved by the other members of the group. Program staff do not conduct loan analysis. The Village Bank receives an initial loan equal to the aggregate amount requested by individual borrowers.
3. Funds lent by the lending institution or NGO are placed into the Village Bank's "External Account" and the Village Bank loans these funds to members. The Village

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Bank must repay the lending institution the original funds with interest in a specified period of time. Bank members are jointly responsible for repayment—if any member fails to repay her personal loan, the other members must make up the deficit. Members are not required to provide collateral or cosigners; instead, the program relies on social pressure to guarantee loan repayment.

The Village Bank manages two accounts. The "External Account", comprised solely of funds lent to the Village Bank by the lending institution, and the "Internal Account". The internal account consists of funds belonging to the Village Bank. The two primary ways the Village Bank accumulates funds in its internal account are:

a) Through regular member savings deposits;

b) If the Village Bank loans funds to members at an interest rate greater than that charged by the NGO or lending institution, interest payments made by members in excess of interest owed to the NGO flow into the internal account

Village Bank members determine the rules for borrowing or using funds from the internal account. Typically, funds that accumulate in the internal account are used to make additional loans to members, or to make up some deficit, should a member default on a loan. Village banks may choose to make higher-interest loans to non-members from the internal account.

The primary goal of the Village Banking model is for the resources in the internal account to grow over time, and displace the need to borrow from a lending institution or NGO. As the Village Bank becomes independent of the lending institution, bank policies become determined democratically by its own members and the bank becomes autonomous and self-sufficient. A noted criticism of the Village Bank model is that Village Banks may not be able to meet this goal because credit demand tends to grow faster than the Village Banks' ability to mobilize savings.

- Community-Managed Revolving Loan Funds (RLF)

The Community-Managed Revolving Loan Fund model is similar to the Village Bank model in important ways. Both models use initial outside funding to work towards the goal of establishing an independent and sustainable bank, run and managed by the local community. Outside funding is channeled directly to the RLF, which then makes loans to individual members. A RLF group typically consists of between 30 and 100 members, often women. Like the Village Bank model, the RLF model requires members to save prior to the initial loan.

There are key differences between the RLF model and the Village Bank model. They include the following:

1. Initial funding can be in the form a grant from an NGO or in the form of a loan. The amount of initial funds provided to a RLF is usually a multiple of the equity, or initial savings, of the group, often no more than $50 per member. When initial funds are provided as a loan, the repayment period is usually long (at least 2 years).[6] After the initial grant or loan, additional funding is usually not provided.
2. Individual loan repayment terms, which are set by the group, may vary greatly within the group depending on the purpose of the loan (short-term working capital loans vs. long-term capital investment or agriculture loans).
3. Member savings, though required for all members in the initial period, may not be required after the initial period.
4. Peer pressure is the primary means to guarantee repayment, but RLF groups may chose to require some form of collateral.

- Savings and Loan Associations

A Savings and Loan Association (SLA) is very similar to a community managed loan fund with one important distinction: funding for SLAs comes from member savings and equity contributions only, and no outside funding is accepted. Savings and Loan Associations are always entirely financially independent of outside institutions, even in the startup period.

Development institutions and NGOs may contribute technical assistance and training in the startup period, but loans are always financed entirely by the member base.

Groups usually consist of between 30 and 100 members. Savings mobilization is an essential feature of this model. Each SLA determines its own rules regarding required member savings amounts. Often, some savings deposit is required of every member at each meeting. Each SLA also determines its own terms and conditions for individual loans. Loan amounts may be determined by the amount an individual has saved with the group, or loan amounts may be uniform across group members. Loan repayment terms can vary greatly within the group, depending on the purpose of the loan (short-term working capital vs. long-term agricultural). Interest rates are often set at an extremely high level as a means to rapidly capitalize group funds.

REGULATORY FRAMEWORK FOR MICROFINANCE IN INDIA

The regulatory framework in a country can have a huge impact on the viability of microfinance. The forms of legal organisation an institution has exemptions available to them, registration requirements, interest rate caps, capitalisation etc. are all determined by the legal framework. The aim of supportive regulatory framework is to build strong regulated and unregulated institutions of all types - to provide services on sustainable basis under uniform, common, shared to encourage the regulatory authority to develop appropriate prudential regulationsperformance standards. and staff capacity that are tailored to the institutions operational and risk profile. This objective requires defining different tiers of financial institutions with different degrees of regulatory requirements. The requirement could vary from

(i) Simply registering as legal entities.

(ii) To prepare and publish periodic reports on operations and financial results

(iii) Observing non-prudential rules of conduct in business operations.

(iv) Securing a proper being and being subject to prudential regulation by a regulatory authority, prudential supervision, or both by a central supervisory authority. The framework identifies different categories and tiers institutional providers of microfinance and specifies the activities that trigger the need for progressively 53 stronger type of regulation and supervision. There is a plurality in the regulatory mechanism - RBI, GOI and State Governments. It is a known fact that the Reserve Bank of India is a super regulator for the financial system. To reach large number of people, microfinance eventually moves through institutions that are licensed and supervised by country's financial authorities. Because microfinance is different from conventional banking, the banking laws and regulations of most countries are gradually being adjusted to accommodate licensed microfinance. Microfinance regulation refers to the set of legal rules that apply to microfinance. Areas of regulation that typically require adjustment include the relaxation of unsecured lending limits, tightening of capital adequacy ratio, strict rules for provisioning for loan losses and lower minimum capital requirements. Since MFIs are generally small institutions than banks or NBFCs. Microfinance regulations refer to the set of legal rules that apply to micro finance. Supervision is in the process of enforcing compliance with those rules. Financial services providers that take deposits need prudential regulation. Regulation helps in long-term sustainability, even though MFIs may safe under it in the initial years. Regulation and supervision ensure that MFIs are run prudently and cases of poor people losing their money due to fraud or incompetence are minimised. Various policies, guidelines, actions / initiatives and programmes of the government and Reserve Bank of India are the indicatives of the recognition and role of the microfinance in the socio-economic development of rural sector in India. Sound and unambiguous legislative framework is a prerequisite for an efficient regulatory system. At present, In India, there are about 60 Acts and multiple rules and regulations, many of which are archaic and the large number of amendments have made the laws ambiguous and complex. Government of India has constituted a 54 financial sector legislative reforms commission (FSLRC) to rewrite and streamline the financial sector laws, rules and regulations to bring them in harmony with India's fast growing financial sector. This study has made an attempt to highlight the policies, guidelines and directives related to field undertaken for research work that is for effective regulation of microfinance activities in India. Some of the fundamentals of regulation should be worthy of recall.

They are - Do not regulate what cannot be supervised. Even carefully developed regulations

- Safety, soundness and sustainability should serve as foundation for a good will become irrelevant if effective supervision is not enforceable.
- There should be regulatory impact assessment as part of the act that should be Micro-finance supervision requires cultural change. regulatory framework. presented to both houses of parliament on the first day of the Budget discussion
- As a basic general principle, microfinance regulation should be uniform across allsession. institutional forms so as to discourage regulatory arbitrage. This involves structuring operations in such a manner that organisation comes under the jurisdiction of a weaker regulator. POLICY GUIDELINES ISSUED BY GOVERNMENT

MAJOR GOVERNMENT POLICY GUIDE LINES :

As per government policy, any financial institution that undertakes microfinance activities, but is not registered as a section 25 company, qualifies as a non-banking finance company and all related regulations apply. The regulation will include registration with the RBI, imposition of prudential norms and compulsory credit rating of deposit taking non-banking finance company.

- Micro-finance institutions registered as section 25 companies can engage in 1 Source - The Journal of Indian Institute of Banking & Finance July-September 2009. P. 23 56 microfinance activity without registering with the RBI or obtaining its permission, microfinance activity is limited to business loan up to Rs. 50,000. Section 25 companies are not allowed to accept deposits.
- With respect to the microfinance activities of a society, the registrar has no responsibility for prudential regulation, financial performance or solvency. The registrar can only intervene if there is a major dispute regarding the management of society, or if registrar suspects fraud against the society's creditors or other unlawful or unauthorised activities.

- Microfinance in India can take many forms and have numerous applicable regulations and responsible regulators. In case of societies and trusts, microfinance activities are largely unregulated and unsupervised.
- Non-banking finance companies and cooperatives are permitted to accept deposits. NBFCs must adhere to additional stringent regulations and cooperatives are only permitted to accept deposits from their members, not the general public.
- No microfinance institution registered as NBFCs accept deposits because•regulation requires that institution must obtain an investment grade rating, which no microfinance institution has obtained.
- In the Finance Bill for the year 2005-06, the microfinance sector has been allowed• access to ECB, provided they - (i) should have a satisfactory borrowing relationship for at least three years with a scheduled commercial bank authorised to deal in foreign exchange and (ii) would require a certificate of due diligence as 'fit and proper' status of the board / committee of management of the borrowing entity from the designated AD.
- All the entities taking up microfinance are allowed to receive grants and 57 subsidised loans from domestic sources. However, in order to obtain grants from foreign sources, institutions must be registered with the Ministry of Home Affairs under the foreign contribution (Regulation) Act 1976. Since, microfinance is largely recognised as a charitable activity, the entire grant meant to support the corpus fund of the society is exempted from taxation.

- Since private trusts taking up micro-finance activities are also subjected to the same provisions of Income Tax Act, their grant income may also be exempted from the taxation. This provision does not apply to cooperative societies, cooperative banks and NBFCs.
- Non Banking Finance Company (NBFCs) can obtain foreign capital in the form of• equity subject to approval by the Foreign Investment Promotion Board (FIPB).
- Cooperative Societies and Cooperative banks, with their distinctly for-profit• constitution can, theoretically, obtain funds from capital market. NBFCs can also access capital markets subject to their adhering to prudential and reporting norms

of RBI. Both types of institutions need to report their capital market transactions periodically to the central bank on prescribed formats.

Impact of Microfinance

Household level :

Microcredit leads to an increase in household income. The use of loans and deposit services can result in a diversification of income sources (e.g., Uganda) or enterprise growth (e.g., Eastern Europe). ·Access to financial services enables clients to build and change their mix of assets. Microcredit can be used for land acquisition, housing construction or improvements, or the purchase of animals and consumer durables. Clients can also use loans to make important investments in human assets, such as health and education. ·Poor people are very vulnerable and move from one crisis to another. Access to microfinance enables them to manage risk better and take advantage of opportunities. In Bolivia, many Pro Mujer clients use loans to protect their level of consumption when crises occur, avoiding large dips in material wellbeing.

Individual level

For women, money management, greater control over resources, and access to knowledge leads to greater choices and a voice in family and community matters. Economic empowerment is accompanied by growth in self-esteem, self-confidence, and new opportunities. In 2002, 103 women clients from Activists for Social Alternatives (ASA) were elected to local councils in India. ·Microfinance clients tend to have higher levels of savings than nonclients, which is very important for building assets. In Zimbabwe, microfinance clients opened accounts in banks or post offices; in Peru, mistrust of formal institutions translated into savings in construction materials and inventory.

Enterprise level

Enterprise revenues rise as a result of microfinance services, but not always where expected. Loans are fungible and are used where the perceived need or return is highest. Between 1997 and 1999, an overall increase in revenues was observed among all enterprises managed by households in India and Peru. But the same studies showed no impact on the specific enterprises for which loans were presumably taken. ·Job creation in single -person enterprises appears negligible. However, when the total number of enterprises is combined, client households often create work for others. For example, in Peru, each microfinance client created three additional working days per month for non-household workers.

Revenue Models of Microfinance

Revenue models can be based on a combination of joining fees, commission fees for both borrowers and lenders for every loan, or commission on monthly repayments. Additional revenues can come from donations, sponsoring partners and advertisers. Many microcredit models use a system of peer support and pressure where borrowers are responsible for each other's success to ensure that every member of their group is able to pay back the loans.

PROFITABILITY EFFICIENCY AND PRODUCTIVITY OF MICRO FINANCE

EFFICIENCY

In the microfinance sector, efficiency can be defined by various ratios with operating expense ratio (calculated as total operating expense to average total gross loan portfolio) being one of the most common. The operating expense ratio includes all administrative and personnel expenses and allows a comparison between an MFI’s portfolio yield with its administrative and personnel expenses – it measures the costs incurred to deliver loans. An MFP is considered to be efficient if it is successful in controlling its operating costs relative to net portfolio.Factors that are considered to drive efficiency include size of organization, interest rate, growth rate, peer group and number of loans per staff.

Growth rate has also been used as an independent variable to determine the efficiency of an organization. It is defined as the percentage increase in the number of active borrowers each year. Growth rate has been used to test the hypothesis that as an organization grows and adds more clients, it can achieve economies of scale and become more efficient or vice versa i.e. growth rate adversely affects efficiency as the operating costs may go up by greater proportion.

PRODUCTIVITY

Productivity is an essential performance indicator that shows how well an organization is streamlining its operations by reflecting the amount of output per unit of input. In microfinance, this is measured in terms of work load of loan officers: the ratio, loans per loan officer, also known as Loan officer productivityis calculated by dividing the number of active loans of an MFP by the total number of loan officers. Loan officers include field personnel or line officers that interact with the client, but not administrative staff or analysts who process loans without direct client contact

Productivity of MFPs is affected by lending methodologies and efficiency. Using a combination of both group and individual lending methodologies results in higher productivity for MFPs. In addition, organizations that have lower expense ratio are also more productive.

PROFITABILITY

Net incomeis the key indicator of profitability and can be called the accounting profit. Due to this it is often referred as the "bottom line". Over the last few years, the NI for the microfinance industry has been positive, driven largely by the increasing yields on the back of correction in asset mispricing.

EMERGING ISSUES IN MICRO FINANCE

here are over 10,000 microfinance institutions serving in excess of 150m customers, 100m of them being the
poorest families. Microfinance is gathering momentum to become a significant force in India. Some challenges
faced by micro finance in India are:

Financial illiteracy

: One the major challenge in India towards the growth of the microfinance sector i.e.
illiteracy of the people. This makes it difficult in creating awareness of microfinance and even more difficult to serve them as microfinance clients.

Lack of information

There are various sources of credit information in India, but none of these focuses onsmall, rural borrowers. Credit information on such borrowers is difficult to obtain because the majority of the rural poor rely on moneylenders and other informal lenders, and it is not in the interest of such lenders to pass on a borrower's good credit repayment record to other providers of finance.

Inability to generate funds

MFIs have inability to raise sufficient fund in the microfinance sector which is
again an important concerning challenge. Through NBFCs are able to raise funds through private equity investment because of the for profit motive, such MFIs are restricted from taking public deposits.

Heavy dependence on banks & FIS

: MIF's are dependent on borrowing from banks & FIS. For most of the MFI's funding sources are restricted to private banks& apex MFI's. In these available banks funds are typically short term i.e. maximum 2 years period. Also there is a tendency among some lending banks to sanction and disburse loans to MFI,s around the end of the accounting year in pursuit of their targets.

Weak governance

Many MFI's are not willing to convert to a corporate structure; hence they trend to remain closed to transparency and improved governance, thus unable to attract capital. MFI's also facing a challenge to strike a balance between social and business goals. Managements need to adapt business models based on changing scenarios & increased transparency; this will enable attracting capital infusion and private equity
funds.

Interest Rate

: MFIs are charging very high interest rates, which the poor find difficult to pay. MFIs are private institutions and therefore require being economically sustainable. They do not get any subsidized credit for their lending activities and that is why they need to recover their operational costs from borrowers

Regional Imbalances:

There is unequal geographical growth of Microfinance institutions and SHGs in India.
About 60% of the total SHG credit linkages in the country are concentrated in the Southern States. However, in States which have a larger share of the poor, the coverage is comparatively low. Main reason for this is the state government support, NGO concentration and public awareness

MODULE – 5b

Financial Inclusion:

Financial Inclusion as defined by RBI Financial Inclusion is the process of ensuring access to appropriate financial products and services needed by all sections of the society in general and vulnerable groups such as weaker sections and low income groups in particular at an affordable cost in a fair and transparent manner by mainstream institutional players

Financial Inclusion – Who are these People?

¬Underprivileged section in rural and urban areas like, Farmers, small vendors, etc.

¬Agricultural and Industrial Labourers

¬People engaged in un-organised sectors

¬Unemployed

¬Women

¬Children

¬Old people

Twin Aspects of Financial Inclusion

Financial Inclusion and Financial Literacy are twin pillars. While Financial Inclusion acts from supply side providing the financial market/services what people demand, Financial Literacy stimulates the demand side – making people aware of what they can demand.

WHAT limits access to financial services?

• Psychological and cultural barriers • Low income • Legal identity-. • Geographical remoteness • Various terms and conditions • Nil or low savings • Lack of awareness/Financial illiteracy • Unemployment/Under Employment • Use of inappropriate products Large section of population financially excluded! Why financial Inclusion? •Economic Objective •Mobilisation of Savings •Larger Market for the financial system •Social Objectives •Sustainable Livelihood •Political Objectives

Reserve Bank of India (RBI) adopts two approaches to achieve Financial Inclusion

• The minimalist approach–availability of basic financial products and services.

• The expanded approach–availability of ancillary financial products such as general insurance, health insurance,micro- pension,housing finance and mutual fund. Both the Approaches form a broader context of economic inclusion.

Financial Inclusion, as the name suggests, is the pursuit of delivering financial services, including payments, savings, credit, etc., to people of low-income and disadvantaged sections of the society at affordable costs. It is also called '**Inclusive Financing**'.

Financial Inclusion's main **objective** is to address constrains that exclude people from participating in the financial sector & make financial services available to them to meet their specific needs without any kind of discrimination.

-With a majority part of the population of the country, being beneft of any financial security, financial inclusion helps in encouraging savings and securing the future of the citizens of all sections.

--The various objectives of financial inclusion are:

1. In the present scenario, rural people tend to spend all they earn on a daily basis, in a short span of time. Financial inclusion will help them in keeping their income secure in the form of savings.
2. Will reduce the exploitation of rural people, at the hands of money lenders
3. Will help in getting institutional credit facilities more easily
4. People will be able to get insurance facilities
5. Will discourage short term unnecessary expenditure and increase their purchasing power in the long run
6. Lesser incidents of deaths due to hunger during droughts
7. More money in the banking system will help the banks to lend more and give impetus to entrepreneurship activities in urban areas and secondary agricultural activities in rural areas.

--Various schemes started by govt to encourage FI are:

1. PMJDY, which gives an additional life and accident insurance to the beneficiaries, to a particular poor section of the society
2. Swabhiman campaign has been started by the govt to raise awareness regarding FI
3. Payment of wages in MGNREGA through the Banking Correspondent (BC) model
4. Introduction of JAM trinity, which merges Jan Dhan Scheme with the Aadhar card initiative and the transactions can be done on mobile
5. Direct transfer of subsidy on LPG and kerosene and fertilizer, etc. to the beneficiaries through their bank accounts.

Micro Finance

Microfinance encompasses the provision of a broad range of services such as deposits, loans, payment services, money transfers and insurance products to poor and low-income households and microenterprises. Microfinance allows replacement of high-cost debt from informal sources, thereby increasing disposable income. It inculcates financial discipline, resulting in ownership of assets, and enhances the ability to withstand shocks due to access to savings products, credit and insurance. In lower income countries with inadequate institutional infrastructure, microfinance is an important development tool and has helped expand the depth of financial services.

Key characteristics of microfinance

It may be belpful to enumerate some of the characteristics associated wit what is perceived to be (Crnicrofinance". There are at least nine tradition< features of microfinance:

(1) Small transactions and minimum balances (whether loans, savings, (insurance).

(2) Loans for entrepreneurial activity.

(3) Collateral-free loans.

(4) Group lending.

(5) Focus on poor clients.

(6) Focus on female clients.

(7) Simple application processes.

(8) Provision of services in underserved communities.

(9) Market-level interest rates.

The Indian Context

With a population of over 1 billion and estimates of the number of poor people ranging from 300 to 400 million, India is one of the largest markets for microfinancial services. It is estimated that a large part of the demand for credit in this stratum is currently met by informal sources. The twentieth century saw large-scale efforts to improve the quality of life in rural India. Different approaches were adopted by government agencies and nongovernment organisations (NGOs) to improve the condition of the rural population. These included land redistribution, building economic and political awareness, technology transfer and delivery of a variety of services. Credit in the rural sector was largely supplied by cooperative societies till the mid-1960s with the commercial banks' rural operations centered around agri-businesses and marketing. One of the objectives of bank nationalisations in 1969 and 1980 was to increase the flow of rural credit. However, merely expanding physical presence in rural areas did not achieve the desired results, given the need to overlay mainstream financial service delivery models with the social mobilisation skills that were essential to meet developmental objectives. The self-help group (SHG)-bank linkage programme was the initial microfinance initiative launched by the National Bank for Agriculture and Rural Development (NABARD) in 1992. While this model of partnership between the banking sector and voluntary organisations achieved reasonable success, it continued to depend on the creation of an extensive banking network. Challenges in scaling up this model led to the introduction of financial intermediation by microfinance institutions (MFIs) that provide microfinance services to the poor, especially in rural areas.

Microfinance Institutions

MFIs borrow from commercial sources and on-lend to clients (groups/individuals). Most MFIs in India started with grants and concessional loans and gradually made Microfinance and Economic Growth – Reflections on Indian Experience 87 the transition to commercial funding. While much of the growth in the initial years was financed by concessional loans from funding agencies, this was followed from 2001 onwards by raising equity from domestic as well as international agencies and by borrowings from the banking sector. MFIs have been observed to administer risks better than the traditional banking sector. There may be two explanations for this:

- MFIs have developed specialised systems of evaluation, supervision, administration and recovery of credits attuned to their clientele, and
- the clients have developed an appropriate financial culture.

Since 2003, several banks have entered the microfinance sector with innovative scaling-up strategies. In addition to term loans, some of the innovative structures offered by banks in India to create access to financial services in the rural areas are:

• Partnership: Several MFIs have an excellent base and infrastructure in their specific markets. However, they lack access to product knowledge, funding and technology platforms. In the partnership model, the bank provides mezzanine equity and technology to the NGO/MFI and lends directly to clients with risk-sharing by the NGO/MFI. The bank also provides loan funds for the MFI's own investment requirements. The MFI undertakes loan origination, monitoring and collection. The advantage of this structure is that it separates the risk of the MFI from the risk of the portfolio. Here the intermediary or the MFI assumes a fraction of the credit risk (to the extent of risk sharing), leading to a reduction in capital required. It combines the core competence of NGOs/MFIs with that of banks – social mobilisation skills with finance.

• Securitisation: In this model the commercial bank identifies a portfolio based on fulfillment of minimum criteria and past portfolio performance. Though the MFI continues to collect receivables from the borrowers, its leverage is reduced which enables it to originate further assets. This product gives the bank the advantage of differentiating between the financial and operational risk of the MFI while credit enhancement improves the rating of the portfolio and enables competitive pricing. The product has highlighted the potential for creating a large secondary market in India for microfinance receivables. Bonds may also be issued against securitised microfinance assets, creating linkages between MFIs and capital markets.

• On-Tap Securitisation: In this product the bank provides the MFI advance funding with which the MFI can build assets. Once created, assets are assigned to the bank. The MFI can continue to build assets and assign them to the bank on a regular basis. 88 K.V. Kamath Microfinance provides a credit delivery channel to rural households. The main impacts of microfinance are increased access to credit for those at the 'Bottom of the Pyramid' with easy and door-step delivery of institutional credit, and, where available, the provision of risk cover for financial losses through a range of insurance products.

Microfinance in India An overview:

The field of microfinance is much researchable. There is a lot of literature on microfinance is available but there is hardly any universally accepted definition of microfinance. Researchers and microfinance visionaries have not a single opinion when it comes to microfinance. According to Sriram and Upadhyayula "It appears that what microfinance means is well understood, but of clearly articulated". However microfinance is term that refers to the provision of a payment services such as deposits, loans payment services, money transfers and insurance to the poor and low income households and their microenterprises. The need of microfinance comes from the disadvantaged sections of the society-who are unable to access to services of formal sector financial intermediaries – and are typically excluded from the formal banking system for lack of survival, collateral, in short the poor and the very poor.

The definitions of these groups vary from country to country. The clients of the microfinance institutes are normally employed in the informal sector, with closely interlinked household and business activities and earning low income. In much narrower sense though, microfinance is often referred to as microcredit for tiny informal business of micro entrepreneurs. Terms micro – loans and micro – crediting did not exist until the '70s of the last century, when Muhammad Yunus, and his Grameen Bank, commenced with his activities in the village Jobra in Bangladesh. He was providing loans to poor women, living in rural areas, for starting a small business aimed at the improvement of their living conditions in their households. Amounts of these loans were minimal, being used for the purchase of small livestock and tools. Women – loan beneficiaries, would form solidarity groups for the purpose of guaranteeing for each other. None of the known collateral forms were used other than their oral promises. Thanks to the Bangladesh's success, Brazil, Peru and many other underdeveloped countries of the world have started with the application of similar programmes. The basic principle of the Grameen Bank was that the clients should not go to the bank, but rather the bank should come to them.

Therefore, officers of micro credit organization worldwide are operating on the field, working from door to door, providing for unfettered access to loans to the people from the remotest areas. In October 2006, Muhammad Yunus won the Nobel Peace Prize for his efforts made in addressing the economic and social development issues, not only in Bangladesh, but all over the world. In the rationale, the Nobel Prize Committee emphasized that the ultimate peace in the world may not be achieved until the majority of the world's population does not find a way out from poverty, and micro - credits represent the right way. Nowadays, micro financing services are provided by more than eight thousand institutions only in the Europe and Central Asia Region, being one of the smallest regions of the world. The total portfolio is exceeding US$ 16 billion, with more than 9 million clients. New data on the number of institutions and clients in the world haven't been released, but it is estimated that the number of clients is exceeding 100 million. Microcredit and microfinance are relatively new terms in the field of development, first coming to prominence in the 1970s, according to Robinson (2001) and Otero (1999).

Prior to then, from the 1950s through to the 1970s, the provision of financial services by donors or governments was mainly in the form of subsidized rural credit programmes. These often resulted in high loan defaults, high loses and an inability to reach poor rural households (Robinson, 2001). Robinson states that the 1980s represented a turning point in the history of microfinance in that MFIs such as Grameen Bank and BRI 2 began to show that they could provide small loans and savings services profitably on a large scale. They received no continuing subsidies, were commercially funded and fully sustainable, and could attain wide outreach to clients (Robinson, 2001). It was also at this time that the term "microcredit" came to prominence in development (MIX 3, 2005). The difference between microcredit and the subsidised rural credit programmes of the 1950s and 1960s was that microcredit insisted on repayment, on charging interest rates that covered the cost of credit delivery and by focusing on clients who were dependent on the informal sector for credit (ibid.). It was now clear for the first time that microcredit could provide large-scale outreach profitably. The 1990s "saw accelerated growth in the number of microfinance institutions created and an increased emphasis on reaching scale" (Robinson, 2001, p.54). Dichter (1999, p.12) refers to the 1990s as "the microfinance decade". Microfinance had now turned into an industry according to Robinson (2001). Along with the growth in microcredit institutions, attention changed from just the provision of credit to the poor (microcredit), to the provision of other financial services such as savings and pensions (microfinance) when it became clear that the poor had a demand for these other services (MIX, 2005).

Evolution of MFIs Industry

Microfinance has built a solid track record as a critical tool in the fight against poverty and has entered the financial mainstream. The rapid growth of the industry over the past 15 years has reached approximately 130 million clients according to recent estimates. Yet microfinance still reaches less than 20 percent of its potential market among the world's three billion or more poor. Nearly three billion people in developing countries have little or no access to formal financial services. Financial services for poor people are a powerful instrument for reducing poverty, enabling them to build assets, increase incomes, and reduce their vulnerability to economic stress. Formal financial services such as savings, loans, and money transfers enable poor families to invest in enterprises, better nutrition, improved living conditions, and the health and education of their children. Microfinance has also been a powerful catalyst for empowering women. The evolution of the industry has been driven by many factors which include the transformation of microfinance providers, the sizable supply gap for basic financial services, the expansion of funding sources supporting the industry and the use of technology. As the industry has developed, there has been a shift from specialized NGOs to an increasing number of regulated and licensed MFIs which stress that sustainability and impact go hand in hand. Furthermore, The World Bank Group is working with private microfinance institutions and stakeholders to incorporate responsible finance practices into all aspects of business operations. Since pioneering commercial microfinance in the early 1990s, IFC has continued to lead innovation in microfinance, using developments in technology, financial products, and policy to help financial institutions reach a greater number of people in a more cost-effective way. IFC's goal for microfinance is to scale up access to a range of high quality financial services for underserved populations, maximizing development impact and ensuring institutional sustainability. IFC achieves this goal by effectively combining investment and advisory services to a range of financial intermediaries. IFC is the World Bank Group's lead investor in microfinance, and is one of the leading multilateral investors in terms of outreach to microfinance institutions, working with more than 100 institutions in over 60 countries. Within the microfinance industry, the majority of MFIs are subsidized, either by governments or by NGOs.

According to the World Bank, although there are over 10,000 microfinance institutions (MFIs), serving over 150 million poor people in developing countries, they only reached 4 percent of the potential market. In the recent years there has been a tremendous growth in the number of microfinance borrowers, growing over the past five years, between 25 and 30 percent annually and it is expected a similar growth in the coming years18 Microfinance industry is segmented, ranging from very small NGOs with few clients to large institutions with millions of clients and it is a highly concentrated industry. One need only consider that the median share of the largest MFI in a country is one third of the entire market and the median share of the top ten MFIs is about 95 percent of the all industry19.The microfinance investment market is also growing in size and maturity and it is increasing the need of investors for transparency through market research, data provider and analysis of MIFs. Transparency is encouraged by the launch of open data for microfinance such as MIXMarket20, which publishes data on more than 1,500 microfinance institutions (MFIs) in more than 190 countries, and helps to build the information infrastructures needed in developing countries. The MIX Market database is publicly accessible and it is a powerful reporting platform for academic researchers, private investors and microfinance institutions.

Microfinance Historical Evolution Worldwide

Traditionally, people have saved with and taken small loans from individuals and groups within the context of self-help to start businesses or farming ventures. These stages are described below: The evolution of Microfinance sector can be broadly divided into four distinct phases:

Phase 1: The cooperative movement (1900-1960) During this phase, credit cooperatives were vehicles to extend subsidized credit to villages under government sponsorship.

Phase 2: Subsidized social banking (1960s – 1990) With failure of cooperatives, the government focused on measures such as nationalization of Banks, expansion of rural branch networks, establishment of Regional Rural Banks (RRBs) and the setting up of apex institutions such as the National Bank for Agriculture and Rural Development. (NABARD) and the Small Scale Industries Development Bank of India (SIDBI), including initiation of a government sponsored Integrated Rural Development Programme (IRDP). While these steps led to reaching a large population, the period was characterized by large-scale misuse of credit, creating a negative perception about the credibility of micro borrowers among bankers, thus further hindering access to banking services for the low-income people.

Phase 3: SHG-Bank linkage program and growth of NGOMFIs (1990 – 2000) The failure of subsidized social banking triggered a paradigm shift in delivery of rural credit with NABARD initiating the Self Help Group (SHG) Bank Linkage Programme (SBLP), aiming to link informal women's groups to formal banks. The program helped increase banking system outreach to otherwise unreached people and initiate a change in the bank's outlook towards low-income families from 'beneficiaries' to 'customers'. This period was thus marked by the extension of credit at market rates. The model generated a lot of interest among newly emerging Microfinance Institutions (MFIs), largely of non-profit origin, to collaborate with NABARD under this program. The macroeconomic crisis in the early 1990s that led to introduction of the Economic Reforms of 1991 resulted in greater autonomy to the financial sector. This also led to emergence of new generation private sector banks that would become important players in the microfinance sector a decade later.

Phase 4: Commercialization of Microfinance: The first decade of the new millennium Post reforms, rural markets emerged as the new growth drivers for MFIs and banks, the latter taking interest in the sector not only as part of their corporate social responsibility but also as a new business line.

On the demand side, NGO-MFIs increasingly began transforming themselves into more regulated legal entities such as Non Banking Finance Companies (NBFCs) to attract commercial investment. MFIs set up after 2000 saw themselves less in the developmental mould and more as businesses in the financial services space, catering to an untapped market segment while creating value for their shareholders. This overriding shift brought about changes in institutions' legal forms, capital structures, sources of funds, growth strategies and strategic alliances.

Phase 1: In the 1960's, the credit delivery system in rural India was largely dominated by the cooperative segment. The period between 1960 and 1990, referred to as the "social banking" phase. This phase includes nationalization of private commercial banks, expansion of rural branch networks, extension of subsidized credit, establishment of regional rural banks (RRBs) and the establishment of regional rural banks and the establishment of apex institutions such as national bank for agriculture and rural development (NABARD) and small scale industries development board of India (SIDBI).

Phase 2: After 1990, India witnesses the second phase ''financial system approach 'of credit delivery. In this phase NABARD initiated the self help group (SHG)-bank linkage program which links informal women's groups to formal banks. This concept held great appeal for non government organization (NGOs) working with poor, prompting many of them to collaborate with NABARD in the programme.

Phase3: In 2000, the third phase in the development of Indian microfinance began, marked by further changes in policies, operating formals, and stakeholder orientations in the financial services space. This phase emphasizes on "inclusive growth and financial inclusion". This period also saw many NGOMFI transform into regulated legal formats such as Non banking finance companies (NBFCs).commercial banks adopted innovative ways of partnering with NGO-MFI and other rural organization to extend their reach into rural markets.

Microfinance Delivery Methodologies and Models

All over the world Microfinance Institutions are using different types of credit lending models to provide microfinance services. A few models are depicted below:

(i) Individual: This model is straight forward in nature. Here, microloans are given to the borrowers directly. It does not depend on formation of groups or generate peer pressures to ensure repayments. In many cases, this individual model is considered as a part of a larger 'credit plan' programme because of providing other socio-economic services such as skill development education and other outreach services.

(ii) Group: The basic philosophy of 'Group Model' lies in the fact that shortcomings and weaknesses at the individual level are lacked by the collective responsibility and security afforded by the formation of a group of such individuals. The group model is used for a number of purposes such as educating and awareness building, collective bargaining, peer pressure etc.

(iii) Rotating Savings and Credit Associations (ROSCAs): Rotating Savings and Credit Associations (ROSCAs) are basically a group of individuals who become together and make regular cyclical contributions to a common fund. Then a lump sum is given to one member in each cycle. For an example, a group of 10 members may contribute Rs.100 per month for 12 months. Then, Rs.1000 is collected at each month and is given to one member. Thus, a member will lend money to other members through his regular monthly contributions. After having received lump sum amount when it is his turn (i.e. 'borrower' from the group), he then pays back the amount in regular or further monthly contributions. Consensus, lottery, bidding or other agreed methods are used for decision taking or receiving the lump sum.

(iv) Peer Pressure: Peer pressure is that instrument which is used for moral and other linkages between borrowers and project participants to ensure participation and repayment in micro-credit programme. Peers could be other members in a borrower group (suppose, unless the initial borrowers in a group repay the other members don't receive loans, hence, pressure is put on the initial members to repay), community leaders (usually identified, nurtured and trained by external NGOs); NGOs themselves and their field officers, banks etc. The 'pressure' applied can be in the form of frequent visits to the defaulter, community meetings where they are identified and requested to comply etc.

(v) Cooperative: A cooperative is known as an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise. Some cooperatives include member financing saving activities in their mandate.

(vi) Non-Governmental Organizations (NGOs): Non-Governmental Organizations (NGOs) are the key players in the field of microfinance. In this field they act as intermediaries. NGOs are too active in starting and participating in microfinance activities. This contains creating awareness of the importance of microfinance within the community as well as various national and international donor agencies. They have developed resources and tools for communities and microfinance organizations to access progress and identify good practices.

They have also created opportunities to learn about the principle and practices of microfinance. This includes seminars, publications, workshops and training programmes.

(vii) Intermediaries: Intermediary model of credit lending is a ‘go-between’ concept between the borrowers and lenders. The links developed by the intermediaries could cover finding, programme links, training, and education and research activities. These activities take place at various levels such as international, national, regional, local and individual. This intermediary model plays a vital role of generating credit awareness, savings programme and education among the borrowers. These activities are geared towards raising the ‘creditworthiness’ of the borrowers to a level sufficient enough to make them attractive to the lenders. Intermediaries could be individual lenders, NGOs, commercial banks (for Government financial programme). Lenders could be Government Agencies, commercial banks, international donors etc.

(viii) Association: In case of ‘Association’ the target community enjoys different microfinance activities. Such activities may include savings, remittances, insurance etc. Youth or women can compose associations. They can form around political, cultural or religious issues and can create support structures for microenterprises. In some countries an ‘association’ can be a legal body that has certain advantages such as collection of fees, insurance, tax breaks and other protective measures.

(ix) Bank Guarantee: Bank Guarantee is used to obtain a loan from a commercial bank. This guarantee may be arranged externally like a donor/ donation, Government Agency etc. or internally such as member savings. Loan obtained may be given directly to an individual or a self-formed group. 40 It is form of capital guarantee scheme. Guaranteed funds may be used for various purposes including insurance claims and loan recovery. Several International and UN organizations have been creating international guarantee funds that banks and NGOs can subscribe to owned or start microcredit programme.

(x) Community Banking: In case of community banking model the whole community is treated as one unit and this model establishes semi-formal and formal institutions through which microfinance is disbursed. These types of institutions are usually formed by extensive help from NGOs. NGOs and other organizations train the community members in various financial activities of the community bank. The structure of these institutions comprise of savings component and other income generating projects. In many cases, community banks are also part of larger community development programmes which use finance as an inducement for action.

(xi) Village Banking: In this type of model, 25 to 50 low-income individuals seek to improve their lives through self-employment activities. This model is basically community based credit and savings associations. An external source may be considered as initial loan capital for the village bank. The members of a village bank themselves run the bank. They choose their members, elect their own officers, establish their own by-laws, distribute loans to individuals, collect payments and accept savings. Their loans are backed not by goods or property but by moral collateral such as the promise that the group stands behind each individual loan.

On the demand side, NGO-MFIs increasingly began transforming themselves into more regulated legal entities such as Non Banking Finance Companies (NBFCs) to attract commercial investment. MFIs set up after 2000 saw themselves less in the developmental mould and more as businesses in the financial services space, catering to an untapped market segment while creating value for their shareholders. This overriding shift brought about changes in institutions' legal forms, capital structures, sources of funds, growth strategies and strategic alliances.

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Application of Different Microfinance Schemes:

the way or the delivery process of the models will 41 be depicted. Generally, in India and particularly in West Bengal microfinance institutions, banks, SGSY model and other institutions follow these two models. In some cases the Grameen Bank Model which is basically introduced and accepted in Bangladesh is also used in our country.

(i) Self-Help Group Model
(ii) SHG-Bank Linkage Model

1. Self-Help Group Model:

The poor people who do not have any security to pledge or no guarantor to take loan for their productive work cannot access any credit facility from formal financial institutions. They depend on only formal money lenders who charge a high rate of interest. Even sometimes they borrow money from relatives, neighbors or their known persons. In this scenario, they feel embarrassed. To provide formal financial services particularly to the lowincome group, the Planning Commission of India suggests about self-help group which is self-governed, peer controlled small and informal association of the poor, usually from socio-economically homogeneous families who are organized around savings and credit activities. To discuss common problems and share information about their activities, members arrange a meeting monthly or fortnightly or weekly. Through mutual assistance group members help each other to change their economic and social problem. Stages of Formation and Development of SHGs: A methodical and scientific approach is followed for long-term sustainability of any informal community based organization. There are four stages from the inception to maturity of a SHG-Forming, Storming, Norming and Performing.

(a) Forming Stage: An animator or a facilitator preferably educated, known to poor villagers and ready to come forward to help the poor people to form a group. This group formation process is encouraged by Self-Help Promoting Institutions (SHPIs)/ Promoting Implementing Agency (PIA) - usually a NGO or an mFI or a bank or any Government

Agency like District Rural Agency (DRA). The duty of an animator is to make understand all the members about the benefits of thrift, the advantages of forming groups, utilization of loan amount and repayment of loan amount. At this stage, groups are identified and group members interact with each other to know and understand themselves better. Information regarding family income, age, name, borrowing amount etc are documented for future use. Self-managed and self-reliant group capacities are established at the community level. The concept and functioning of microfinance and SHG are explained to the group members.

(b) Storming Stage: In this stage, group members are motivated about the principle of self-help group and sensitization process takes place. The concept 'United we stand and divided we fall' is delivered to each SHG member. If there are any previous conflicts or confusions among the group members, at this stage those are resolved. At the end of this stage, a decision-making capability within the group is evaluated.

(c) Norming Stage: In this stage, the individualistic tendencies are replaced by collectiveness. As a result of this, the group becomes more cohesive and development oriented. The group evolves group norms and the group solidarity comes into force.

(d) Performing Stage: In this final stage, this group becomes ready to act. Here, leadership is established. Clarity of role is developed and the group behaves in a unified manner to achieve its mission with the help of collective action.

Functioning Structure of SHGs:

(i) Size of a SHG: As the SHG is an informal group, there is minimum ten members and maximum twenty members. If the group members exceed twenty then the group should be registered.

(ii) Membership Pattern: As per the guidelines of NABARD, to include more family in a SHG, a member from each family can join the group. For easy communication, all members from the same village are selected. To keep good interaction among the members, the members are selected from same economic and social background.

(iii) Election of Group Leader: Democratically, the group leader is elected by the group members. The leader has the responsibility to organize the group meetings, chair the proceedings, maintain the group records and help to facilitate the process of banking and other economic and social contacts.

(iv) Group Meetings: The group meetings are organized to make the group-members understand about their difficulties weekly/ fortnightly/ monthly. Attendance is compulsory to attend the meeting. Absence may attract charges as penalty. In the meeting all the problems faced by the members are discussed such as major decisions regarding saving and lending transactions are taken. The group-members decide the date and venue of the meetings and savings of all individuals are collected in the meeting.

Books Kept by a SHG:

(a) Minute Book: In this book, the names of the members, rules, regulations and proceedings of the meetings are recorded.

(b) Weekly/ Fortnightly/ Monthly Registers: In this book, the summary of receipts and payments are kept.

(c) Savings and Loan Register: Individual and group savings are recorded in this book. Individual loans, repayments, interest collected, balance etc. are entered here.

(d) Member's Passbook: Individual's savings and loan balance outstanding is regularly updated here.

Mechanism of Saving and Lending:

Saving and Thrift: 'Saving first-credit later' is the motto of every SHG. On a regular interval, the group members save a small amount (Rs.50 to Rs.100 per month). It inculcates saving behavior among the group members. In this way the members become disciplined in financial matters which help them in handling bank loans.

Bank Account: After one or two meetings, the SHG passes a resolution in the group meeting, signed by all members to open a saving account in the name of a SHG. As per rule the SHG authorizes at least three members to operate the bank account. The mode of operation may be jointly by any two or all the three members. The resolution along with the filled up application form and a copy of the rule and regulations of the SHG is filed with the bank. The bank issues a saving bank passbook to the SHG.

Internal Lending: For a minimum period of two to three months saving is kept. The group starts lending to its members at a pre-decided interest rate from the common 45 savings fund. The terms and conditions for advancement of loans are predecided. For consumption and production purposes intra-group loans are available and interest vary between two to four percent per month.

External Lending: In this stage, SHG seeks external credit from bank. It takes six months when the group- members become habituate in savings and learn to manage, utilize and repay their loans. The bank assess the performance of the group based on certain sixteen parameters such as group size, regularity of meeting, saving collection, utilization of savings, loan recoveries etc. The bank issues loan in the name of a SHG being satisfied with the viability of the group. Generally, the quantum of the loan varies from one to four times of the savings amount. The loan amount may be more than the specified if the bank satisfies with the performance of the SHG.

Further Lending Activity: Further lending is given to the group-members depending on the circumstances of the members. First of all, the need and purpose of lending is verified. The purpose can be for buying an asset to generate income or emergency needs like illness, marriage etc. The interest earned is deposited in the account as a part of a group fund also. Repayment of Loan: For repayment of external loans the group remains collectively responsible. The SHG makes a small and regular repayment schedule. Willful defaulters are discouraged by peer pressure, peer support and peer monitoring. The promoting institution arranges training programmes because the group has common income generating activities. It is necessary for each member to realize that money belongs to not only him/ her but also other member of the group.

SHG Linkage Models of NABARD:

Basically, there are three types of SHG models in the SHG-Bank Linkage programme of NABARD. These models are discussed below:

1. **SHGs formed and financed by Banks:**

In this model, bank themselves take initiative of forming and nurturing the groups. The bank itself acts as a Self-Help Promoting Institution (SHPI). Although this model has not flourished so much. Bankers do not want to go for social mobilization. The core competence of a bank is to finance, not forming SHGs themselves. SHGs are formed for limited purpose of fund rotation. SHGs help banks to expose into social realities. In all places NGOs do not work. At those places banks provide the accessibility of microfinance services. In this model, 20% SHGs, RRBs, Commercial Banks, DCCBs and PACs are included. Here costs of borrowing vary from 8.7% to 13.6%;

2. SHG-Bank Linkage Model or SHGs directly financed by banks but formed by formal agencies other than banks, NGOs and others:

In this type of model, NGOs, Government Agencies and other community based organizations help to form groups and plays as a facilitator of the group. It is the most commonly adopted model. One of the benefits of this model is that each type of institution acts the best suited role for it. Here, the local facilitators and SHGs learn how to deal with an accessible bank branch and vice-versa. The process includes- banks lending, facilitators mobilize communities into SHGs and SHGs manage small groups finance according to their interest and needs. About 75% of NABARD's microfinance till March, 2002 used this model of linkage. In this case of model, the cost of borrowing ranged from 9% to 12%;

3. MFI-Bank Linkage Model or SHGs financed by banks through NGOs and other agencies as financial intermediaries:

For this model , two types of situations are involved- one, well-established NGOs provide financial services to the communities they work with and the next one, the local bankers who are willing to channelize the funds through the local NGO but still do not have adequate exposure or faith in lending directly to the SHGs. Here, NGOs or mFIs are encouraged to approach a suitable bank for bulk loan assistance as well as take additional role of financial intermediation because formal banks face constraints to enter into. In some cases, a large number of SHGs have been financed by bank branches. Intermediate agencies like federation of SHGs are acting as link between bank branch and member SHGs. About 74% SHGs including State Governments in Andhra Pradesh, Rajasthan and Madhya Pradesh belong to in this model. In this model, the cost of borrowing vary from 12% to 21%; In Tamil Nadu, West Bengal and Rajasthan, the high cost of borrowing of this model was mainly due to high rate of interest cost which is 15% to 17.5%; Here, relatively high cost of lending occurs due to less diversified activities of mFIs vis-à-vis banks.

Legal and Regulatory Framework of Micro finance:

In India microfinance institutions have different legal forms. Different governance structures are results of the different legal formats. Economic growth and success of any organization depends on Governance. Variety of legal forms of microfinance institutions are described below

Societies: Societies are governed by the Societies Registration Act, 1860. Various states have adopted this act. Usually, a managing committee or a Governing Council manages the societies. Basically, societies are membership organizations that may be registered for charitable purposes. Registration of a society is very easy and can be obtained within weeks. A society requires no minimum start-up capital. As per RBI guidelines in case of a society deposit mobilization is not allowed. The operational system of a society may be problematic as the funds for up scaling would be hard to rise and ineffective management could hamper growth. Societies are allowed to borrow external funds if certain criteria meet and memorandum of association permits commercial borrowing. Grants and subsidized loans are allowed and can be exempted from tax if used for charitable purposes.

Trusts: In India the public charitable trust is a possible form of not-for-profit entity. Public charitable trusts can be established for a number of purposes including education, relief of poverty, medical relief, provision of facilities for recreation and any other object of general public utility. States like Maharashtra, Gujarat, Rajasthan and Madhya Pradesh Public Trust Act is followed. Private trusts are governed by the broad principles of the India Trust Act, 1882. No National law governs public charitable trust in India. Generally, Indian trusts are irrevocable. Like societies the registration process of trusts is very easy and can get within weeks. For a trust no startup capital required. Deposit can be mobilized in the case of private and mutually-aided trusts but mobilisation is not allowed in public charitable trust. In case of a trust, trust deed must permit commercial borrowing. External Commercial Borrowing is allowed if some criteria meet. Grants and subsidized loans are allowed and are exempted from tax if used for charitable purposes.

Section 25 of the Companies Act, 2013: Section 25 of Companies Act may be formed for “promoting commerce, art, science, religion, charity or any other useful object”. No profits, if any or other income derived through promoting company’s object may be distributed in any form to its members. No specified minimum amount for capitalization and no capital adequacy are maintained by Section 25 Companies. In case of Section 25 Companies, authorised capital is declared at the time of registration with the Registrar of Companies. If any changes occurred in authorised capital, approval should be taken by the Registrar. External Commercial Borrowing is allowed if some criteria fulfills. Grants and loans are allowed and exempted from tax. Foreign Direct Investment is allowed but not-for-profit nature of institution makes it incompatible with investor interests. There is no restriction in investing capital markets but the not-for-profit nature makes it incompatible with market requirements. Section 25 Companies comply with provisions of Company Law and report to the Registrar of Companies on annual basis essentially accounts, shareholding pattern and board membership.

Non Banking Financial Companies (NBFCs): Non-banking financial companies are registered under the Comopanies Act and licensed by RBI as Non Bank Institutions known and Loan Companies, Housing Finance Companies, Investment Companies etc. Some NBFCs are registered and some are not registered. Commercial mFIs are regulated under NBFCs. They are engaged in financing other entities, purchasing government securities and other business and are permitted to lend, hirepurchase or lease. Deposit mobilization is granted if they are rated by approved credit rating agencies. Only time deposits of 1-5 years are permitted.

Impact of Micro finance

The good news is that impact assessments have demonstrated that financial services for the poor improve people's lives by increasing their incomes and improving their capacity to pay for social services. However, although microfinance is an important catalyst for poverty reduction, it is not a magic bullet. The climb out of poverty tends to be slow and uneven.

Impact is about understanding how financial services affect the lives of poor people. To date, most impact assessments have focused on microcredit programs rather than looking at a range of financial services. · Impact considers income growth, asset building, and reduction of vulnerability. · Impact indicators extend beyond enterprise measures (assets, employment, revenues) to include multiple dimensions of poverty, including overall household income, social improvements in health and education, and empowerment (in terms of increased self-esteem and control of household resources among women).

What do we know about the impact of microfinance?

1. Outreach is important. Financial institutions must reach poor clients to have an impact. As shown in the graphic, most microfinance clients today fall in a band

around the poverty line. The extreme poor are rarely reached by microfinance. (Social safety net programs are often more appropriate for the destitute and extreme poor.) ·

2. Product characteristics count. Specific characteristics of financial products, such as loan terms and transaction size, affect impact. Shortterm working-capital loans may work well for traders wanting to purchase inventory. For producers who need to make one-time investments in equipment purchases, however, they work less well. These clients may require other services like term savings or longer-term loans. ·
3. The asset base of clients is relevant. The initial resource base of a client affects impact. The impact of financial services on clients who begin with more resources (financial, physical, or social) tends to be greater than on clients who start from a very low resource base. ·
4. Sustainability matters. The length of time that an individual has been a client of an institution has a positive correlation with impact. Sustainable institutions ensure ongoing impact by providing permanent access to services. ·
5. Country context is a factor. The macroeconomic, legal, and policy environments seriously affect impact. Poor economic conditions, weak social and physical infrastructure (education, health, roads), corruption, and lack of security adversely influence the ability of clients to benefit from financial services.

What is the impact of mic rofinance?

1. Household level ·
   - Microcredit leads to an increase in household income. The use of loans and deposit services can result in a diversification of income sources (e.g., Uganda) or enterprise growth (e.g., Eastern Europe).
   - Access to financial services enables clients to build and change their mix of assets. Microcredit can be used for land acquisition, housing construction or improvements, or the purchase of animals and consumer durables. Clients can also use loans to make important investments in human assets, such as health and education.
   - Poor people are very vulnerable and move from one crisis to another. Access to microfinance enables them to manage risk better and take advantage of opportunities. In Bolivia, many Pro Mujer clients use loans to protect their level of consumption when crises occur, avoiding large dips in material wellbeing.

2. Individual level ·

- For women, money management, greater control over resources, and access to knowledge leads to greater choices and a voice in family and community matters. Economic empowerment is accompanied by growth in self-esteem, self-confidence, and new opportunities. In 2002, 103 women clients from Activists for Social Alternatives (ASA) were elected to local councils in India.
- Microfinance clients tend to have higher levels of savings than nonclients, which is very important for building assets. In Zimbabwe, microfinance clients opened accounts in banks or post offices; in Peru, mistrust of formal institutions translated into savings in construction materials and inventory.

3. Enterprise level ·

- Enterprise revenues rise as a result of microfinance services, but not always where expected. Loans are fungible and are used where the perceived need or return is highest. Between 1997 and 1999, an overall increase in revenues was observed among all enterprises managed by households in India and Peru. But the same studies showed no impact on the specific enterprises for which loans were presumably taken.
- Job creation in single -person enterprises appears negligible. However, when the total number of enterprises is combined, client households often create work for others. For example, in Peru, each microfinance client created three additional working days per month for non-household workers.

How could financial services achieve greater impact?

To date, microfinance has mostly offered microcredit designed for high-turnover microenterprises. Most impact assessments have focused on this type of microcredit. But evidence shows that clients adapt these rather rigid loans to use them for a variety of purposes like medical expenses, funerals, and school fees. Microfinance could achieve greater impact if it offered a broader range of financial services that better met the varied needs of the poor, including deposit services, micro insurance, and transfer payments.