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ANALYZING THE IMPACT OF LEGAL FORM OF INDIAN MICROFINANCE INSTITUTIONS ON FINANCIAL SUSTAINABILITY AND OUTREACH

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ABSTRACT

India boasts the largest microfinance market in the world, serving almost 40 million clients through about 220 registered institutions. Microfinance quickly became a popular industry for both business practitioners and researchers due to its ability to reduce poverty. While the industry has been doing well in serving the poor, it is still not reaching everyone that it could. There is room for improvement, and analyzing the legal forms of the industry would help. The current legal landscape of India allows microfinance institutions to take one of five legal forms: (1) Society, (2) Trust, (3) Section 25, (4) Cooperative, and (5) Non-Banking Financial Company. Each form differs in the amount of regulation it must go through, how it can raise capital, rules for formation, taxation, and services it is allowed to perform. This thesis suggests that the form of microfinance institution plays a large role in determining its effectiveness. It considers the laws that govern the microfinance institutions and analyzes the effects of these laws on two important metrics for effectiveness: profitability and client outreach. The thesis explores each legal form by analyzing a company of each type both qualitatively and quantitatively; after that legal forms are analyzed at the industry level. It finds that, at the industry level, Non-Banking Financial Companies are the most financially sustainable legal form and the most successful at client outreach. Therefore, Non-Banking Financial Companies should be promoted in India to make sure microfinance is reaching as many people as it can. Other developing countries around the world can employ some of the effective features of Non-Banking Financial Companies to ultimately reduce poverty in their nations as well.

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Introduction

Less than two dollars – that is the amount of money that over 10% of the world's population lives on every day.[1] Such extreme poverty is a global issue that is a constant target for action, but still seems to linger. In 2000, during the Millennium Summit, the UN announced Millennium Development Goals that sought, in part, to eradicate poverty by 2015.[2] Several countries submitted plans to achieve these goals during the International Conference for Financing International Development; For example, many UN member countries agreed to donate at least .7% of gross national product to development aid so as to establish a set amount that should be contributed by each country.[3] Yet despite the new measures, we still live in a world burdened with poverty.[4]

Nasim Bee is a 37-year-old woman from Alirajpur, Madhya Pradesh, India whose struggle is emblematic of the problem. Her life descended into instability at the age of 18 when her husband died.[5] She has a son who earns about 6,000 rupees (approximately $90) per month as a driver, nearly all of which he allocates to raising his two children.[6] Nasim, who is trained as an experienced seamstress, wanted to contribute to her family's income; however, she had no means of monetizing her skill since she could not afford a sewing machine of her own.[7] That was until she learned about the financial services from PRAYAS, a microfinance institution that runs initiatives to help poor communities and provides loans to those who cannot acquire them from a traditional bank.[8] With a 7,000 rupee loan from PRAYAS,

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[1] World Bank, *Overview*, http://www.worldbank.org/en/topic/poverty/overview (last updated Oct. 2, 2016).
[2] http://www.unmillenniumproject.org/goals/
[3] United Nations, RESOLUTIONS ADOPTED BY THE GENERAL ASSEMBLY, at 5 (2005), http://www.unmillenniumproject.org/documents/UNworldsummit.pdf
[4] Michael S. Barr, *Microfinance and Financial Development*, 26 MICH. J. INT'L L. 271, 271 (2004).
[5] PRAYAS, ANNUAL REPORT 2014-15, at 22 (2015), http://www.prayas4development.org/reports/Prayas%20Annual%20Report%202014-15.pdf.
[6] *Id.*
[7] *Id.*
[8] *Id.*

Nasim bought a sewing machine to start stitching and selling women's dresses.[9] Nasim found enough success to take out another loan of 10,000 rupees to start making and selling other accessories.[10] Today, Nasim is earning 3,500 rupees per month, after deducting her loan payment.[11] She is now able to sustain herself financially, and plans to save for her grandchildren's educations.[12] PRAYAS shared Nasim's success story in an annual report to the highlight the impact of microfinance and encourage others to borrow.

Another difficult story with an inspiring outcome involves Bandaru Lakshmi, from Suryapet, Telangana, India. She lived day to day without stable income, her husband's business was performing poorly, and she could not find a lender from which to obtain a loan.[13] However, when Bandaru learned of SKS Microfinance's operation in her village, she was able to take out an income-generating loan of 10,000 rupees.[14] SKS Microfinance is a non-banking financial company that aims to eradicate poverty by giving the poor access to financial services.[15] With her funds from SKS, Bandaru bought and sold readymade garments in nearby villages.[16] She found success in her reselling business and eventually took out two additional loans of 12,000 and 14,000 rupees for more cloth.[17] Bandaru clearly had the sales skills and a drive for success, but could not obtain a traditional loan due to her financial condition. She now makes 30,000 rupees per month and was able to provide a decent education to her children.[18] The people of Suryapet respect Bandaru for her success and are inspired to break free from the clutches of poverty.[19]

Nasim's and Bandaru's success would not have been possible without microfinance. If they were to obtain loans from a traditional bank, they would need some form of collateral and undoubtedly have to

[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] Crossroads' Global Hand, *SKS Microfinance Case Study: Lakshmi's Story,* https://www.globalhand.org/en/search/success+story/document/28296 (last accessed March 1, 2017).
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *Id.*

pay a dangerously high interest rate. Many people have the skills and determination to work for a better life, but cannot gain access to traditional financial services. Microfinance is the key for these people like Nasim, Bandaru, and millions of others to gain financial inclusion and rise above poverty.

Sa-Dhan, a self-regulated organization of microfinance institutions in India, provides a good working definition of microfinance: "the provision of thrift, credit, and other financial services and products of very small amounts to the poor in rural, semi urban, or urban areas, for enabling them to raise their income levels and improve living standards."[20] Through these financial services, microfinance institutions seek to spread financial inclusion. According to EY, the main objective of financial inclusion is to ensure access to formal credit for people who depend on informal sources for fulfilling their needs, at an affordable cost in a fair and transparent manner, and to promote financial education.[21] It is through these services that microfinance institutions like PRAYAS and SKS Microfinance are able to provide financial inclusion to the poor in hopes of helping them escape poverty.

Since its inception in 1974, microfinance has grown substantially in India.[22] And while it is currently reaching nearly 40 million clients, there is room for improvement.[23] The broad classifications of microfinance in India can be broken up into three segments: government, private sector, and charities.[24] Founders have used various laws to form these organizations; it is generally acknowledged that there are five different legal forms of microfinance institutions: societies, trusts, Section 25s, cooperatives, and Non-Banking Financial Companies (NBFCs).[25] Societies, trusts, and Section 25s are charities. Cooperatives will differ in classification depending on state laws. NBFCs are private and for-profit.

[20] SA-DHAN, DIRECTORY OF MICROFINANCE INSTITUTIONS (MFIS) IN INDIA, 6 (2016), *available at* http://www.sa-dhan.net/Resources/booklet%20inner%20pages%20final.pdf (hereafter SA-DHAN DIRECTORY)
[21] ASSOCHAM (EY), EVOLVING LANDSCAPE OF MICROFINANCE INSTITUTIONS IN INDIA, 3 (2016), *available at* http://www.ey.com/Publication/vwLUAssets/ey-evolving-landscape-of-microfinance-institutions-in-india/$FILE/ey-evolving-landscape-of-microfinance-institutions-in-india.pdf.
[22] SEWA Bank, *the SEWA Bank*, http://www.gdrc.org/icm/inspire/SEWA.html (last accessed March 1, 2017).
[23] SA-DHAN, THE BHARAT MICROFINANCE REPORT 2016, at 17, *available at* http://sa-dhan.net/Adls/Microfinance/Sector%20Reports/The%20Bharat%20Microfinance%20Report%202016.pdf (hereinafter, SA-DHAN BHARAT REPORT)
[24] T.S. Devaraja, *Microfinance in India : A Tool for Poverty Reduction*, 3 (2011), *available at* http://sibresearch.org/uploads/2/7/9/9/2799227/microfinance-_devaraja.pdf
[25] SA-DHAN DIRECTORY, *supra* note20, at 6.

Each of these legal forms differs in several aspects, including services each institution can offer, the amount of regulation each institution must undergo, the tax structure of the institution, and how it can raise capital, thus directly influencing the financial sustainability and client outreach capabilities of the microfinance industry in India. Due to the aforementioned differences, it is reasonable to assume that one form is more financially sustainable than others. Similarly, one would expect that one form is most able to reach clients effectively. Intuitively, the two factors should be related, as the number of clients served is impacted by financial sustainability; a business that is financially sustainable will operate well into the future. The longer a microfinance institution operates, the longer it will be able to spread financial inclusion and improve lives of the impoverished. Therefore, it is important to determine which legal form is the best in terms of financial sustainability and client outreach, because that one is likely to be the most effective at reducing poverty. Promoting the most effective legal form could solve the problem that Indian microfinance is not reaching everyone that it could.

To date, such an analysis on legal form as the determinant of differences in outreach and financial sustainability has not been completed. This study contributes to the literature by determining why a legal form is likely to be outstanding in effectiveness. In Chapter 1, the thesis will provide background information on microfinance, the Indian microfinance industry, and previous studies regarding the financial sustainability of microfinance institutions. Then, Chapter 2 describes the history and the details of the laws that govern the different legal forms of microfinance institutions in India. Chapter 3 presents examples of each legal form, analyzing them both qualitatively and quantitatively. Next, Chapter 4 provides analysis of the industry as a whole, and discusses why the numbers appear as they do. The metrics used for analysis in both Chapters 3 and 4 are client outreach and returns on assets and equity; they are introduced in Chapter 3 and more thoroughly discussed in Chapter 4. Finally, Chapter 5 discusses the implications of this study on the global microfinance community.

Chapter 1

Microfinance Institutions Have Grown From Informal and Unsustainable Beginnings to an Organized and Financially Viable Industry

To get a better understanding of the need for and the growth of the microfinance industry, it is worth looking at its history. The concept of microfinance has been around for centuries, perhaps millennia, depending on where you look. There are examples of microfinance in the 1700's in Ireland with the appearance of self-help charities known as Loan Funds, as well in Germany with the birth of credit and savings cooperatives.[26] In India, however, microfinance traces back to the emergence of and interactions between guilds of traders, moneylenders, and merchant bankers between 200 B.C. and 300 A.D.[27] Different castes were charged different interest rates; for example, the poor were often given interest-free loans thus marking the start of social banking.[28] These historical roots, even though they were unsustainable, set up a foundation for today's sustainable practices to build upon.

While the concept of microfinance has been around for a while, the idea of an organized and sustainable microfinance model is often credited to Muhammad Yunus.[29]Yunus started experimenting with the idea of microfinance in 1976 while he was a professor of Economics at Chittagong University in Bangladesh.[30] He lent out $27 from his own pocket to 42 needy people in the village of Jobra, and was

[26] Hans Dieter Seibel, *Does History Matter ? The Old and the New World of Microfinance in Europe and Asia*, *2-3* (Oct. 8, 2005), *available at* https://www.econstor.eu/bitstream/10419/23654/1/2005-10_The_Old_and_the_New_World_in_Europe_and_Asia.pdf.
[27] *Id.* at 7.
[28] *Id.*
[29] MAHABUB HOSSAIN, CREDIT FOR ALLEVIATION OF RURAL POVERTY : THE GRAMEEN BANK IN BANGLADESH 7 (1988), *available at* *https*://books.google.com/books?hl=en&lr=&id=T0zEM_jw2coC&oi=fnd&pg=PA7&dq=grameen+bank+history&ots=0vq68YEpq9&sig=YOWcpU2InxeokYTb_Z3gPaR1ugM#v=onepage&q=grameen%20bank%20history&f=false
[30] Muhammad Yunus, *The Grameen Bank*, *116* (1999), *available at* http://www.academia.edu/9279637/The_Grameen_Bank

impressed to see them pay back the loans in full.[31] He kept expanding his work to other villages and continually saw them pay back the loans without default. Then, in 1983, and with the help of the Bangladeshi government, Yunus formed the Grameen Bank.[32] Going against conventional banking, Grameen Bank's practice of seeking out the poorest borrowers and requiring no collateral made it an effective means of catering to the poor.[33] For that reason, components of the Grameen Bank Model are now utilized by organizations across the globe.[34] For example, the concept of forming small groups to guarantee loan repayment and to supervise loan utilization is seen in India through the Self-Help Group Model.[35] Today, over forty countries apply the Grameen model as a tool against poverty.[36] India, a neighbor to Bangladesh, is one of these countries.

The Indian Microfinance Industry is the Largest in the World

India is home to over 1.1 billion people, with 27.5% of them living in poverty.[37] That is the same as 85% of the population of the United States living in poverty in a country that has just one-third of the land mass.[38] Poverty is a prevalent issue in India. The desire to eradicate poverty in the desperate and impoverished India was so strong that, as soon as Yunus established his sustainable and successful Grameen Bank Model, India was eager to try it.

The first prominent Indian microfinance institution was the Self-Employed Women's Association Bank (SEWA Bank), founded in the 1970's.[39] The institution was founded as a savings and credit cooperative by four thousand women in order "to provide credit to self-employed women with the view to

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[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] *Id*, at 118.
[35] *Id.*
[36] *Id.*
[37] Lamar Dowling, *The Indian Microfinance Institutions (Development and Regulation) Bill of 2011 : Microfinance beginnings and Crisis and How the Indian Government is Trying To Protect Its People*, 45 INT'L LAW. 1083, 1085 (2011).
[38] World By Map, *Land Area*, http://world.bymap.org/LandArea.html (last updated Jan. 1, 2017).
[39] Devaraja, *supra* note 24, at 3.

empower them and reduce their dependence on money sharks."[40] SEWA Bank is focused on women's economic and social conditions, and has helped thousands of women by providing banking infrastructure so that they could purchase the items they needed to start up businesses.[41] After seeing the positive impact of SEWA Bank on the community, other microfinance institutions followed suit and became established around the country to promote financial literacy and financial inclusion.

The Indian microfinance model generally reaches its clients through groups. There are two common types of groups, and both Self-Help Groups (SHGs) and Joint Liability Groups (JLGs) are keystones in Indian microfinance, as they are the primary mode used to reach clients. Self-Help Groups are defined as mutual assistance organizations through which individuals undertake collective action in order to improve their own lives.[42] Joint Liability Groups are "an informal group comprising preferably 4-10 individuals coming together for the purpose of availing bank loan either singly or through the group mechanism against a mutual guarantee."[43] Microfinance institutions lend to these groups due to the increased safety of their loans; members of groups engage in collective bargaining, peer education, social support, and risk spreading.[44] Therefore, it is in the best interest for all members to help each other pay off their loans since their ability to get a loan in the future is at stake.

In India, these SHG consists of several village members, usually female, who serve as financial intermediaries that can create savings or engage in lending within the village.[45] In 1992, the National Bank for Agriculture and Rural Development (NABARD) started the SHG-Bank Linkage Program to help integrate the formal financial system with the informal groups.[46] The movement was a huge step for

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[40] SEWA Bank, *supra* note22.
[41] *Id.*
[42] *Id.*
[43] https://www.nabard.org/pdf/JLGs_Sharing_Liabilities_Creating_Assets.pdf (page 10)
[44] Pierre Biscayne, Zoe Tru, Christopher Clark, Katie Harris, C. Leigh Anderson & Mary Kay Gugerty, *Self-Help Groups in Development : A Review of Evidence from South Asia and Sub-Saharan Africa*, EPAR Brief No. 281, at 1 (Dec. 5, 2014), https://evans.uw.edu/sites/default/files/EPAR_283_SHG%20Evidence%20Review%20Brief_12.5.14_0.pdf.
[45] *Id.* at 2.
[46] A. Amerender Reddy & Dharm Pal Malik, *A Review of SHG-Bank Linkage Programme in India*, 7 INDIAN J. OF INDUS. ECON. & DEVELOPMENT 1, 1 (2011), https://www.microfinancegateway.org/sites/default/files/mfg-en-paper-a-review-of-shg-bank-linkage-programme-in-india-dec-2011.pdf

Indian microfinance, as it "is considered the largest community based programme in terms of outreach in the world…"[47] The idea of linking banks to SHG's has helped the movement to reduce poverty in India and has made the work of microfinance institutions in India more effective.

JLGs are more directed to farmers and entrepreneurs because they can take out larger, longer-term loans and meet infrequently, unlike SHGs.[48] Through JLGs and SHGs, much more of the country has the ability to gain access financial services. Microfinance institutions of all five legal forms work with SHGs and JLGs to spread financial inclusion sustainably and effectively.

According to Sa-Dhan, there are currently 223 recognized microfinance institutions in India, serving 21 of the 36 states and union territories.[49] Through the help of the group lending models, total client outreach by Indian microfinance institutions has reached 39.9 million people, as of 2016, with 97% of borrowers being women.[50] The Indian microfinance industry is very top-heavy, with the top 10 largest organizations reaching 26.2 million people.[51]

Previous Studies on Factors Affecting Financial Sustainability of Microfinance Institutions

While the microfinance industry is making progress at reaching clients, financial inclusion has yet to spread around all of India. Vikram Akula, founder of SKS Microfinance, published an article in the *Harvard Business Review* giving an overview on microfinance. According to Akula, "Microfinance is often lauded as the solution to poverty".[52] He goes on to describe the borrowers as agricultural laborers, mom-and-pop entrepreneurs, vendors, and artisans all living on less than $2 a day.[53] However, Akula mentions that the industry has only reached 140 million people globally, and that 3 billion still live on less

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[47] *Id.* at 2.
[48] NABARD, JLGS SHARING LIABILITIES CREATING ASSETS, at 10 (2014), *available at* https://www.nabard.org/pdf/JLGs_Sharing_Liabilities_Creating_Assets.pdf.
[49] SA-DHAN DIRECTORY, *supra* note 20, at 7.
[50] SA-DHAN, MICROFINANCE SECTOR : A SNAPSHOT OF 2015-16, at 2 (2016), *available at* http://www.sa-dhan.net/Resources/flyer%20low.pdf (hereinafter SA-DHAN SNAPSHOT)
[51] SA-DHAN BHARAT REPORT, *supra* note 23, at iii.
[52] Vikram Akula, *Business Basics at the Base of the Pyramid*, HARV. BUS. REV., June 2008, https://hbr.org/2008/06/business-basics-at-the-base-of-the-pyramid
[53] *Id.*

than $2 a day (only 19% market penetration). Since this was as of 2008, market penetration has undoubtedly increased; nonetheless, there is still room for improvement. The source of this poor penetration is "lack of access to commercial funds, the high cost of handling millions of micro-transactions, and inability to create scalable operating systems".[54] Many have tried to study why microfinance institutions are not reaching the poor, and how their profitability is affected by different factors.

A study conducted by Jonathan Adongo and Christoph Stork focusing on microfinance in Namibia revealed that donor involvement in providing start-up funds is positively correlated with financial sustainability, group lending strategies can be paired with other credit and risk management tools to reduce default rate, and a lower per capita income of the location does not affect financial sustainability.[55] They also found that more clients and larger loan sizes were positively correlated with financial sustainability.[56]Additionally, Adongo and Stork claim that "improving the reliability of reported information for the selected microfinance institution is a key issue that needs to be addressed by both regulators and practitioners".[57] The better a company is at reporting and measuring metrics, the faster they will achieve financial sustainability.

Another study conducted by Bayeh Kinde studied financial sustainability of microfinance institutions in Ethiopia. Out of all the tested factors, Kinde found that breadth and depth of outreach were positively correlated with financial sustainability while cost per borrower was negatively correlated.[58] In other words, if a microfinance institution has more clients, larger loan sizes, and lower costs per borrower, they will be more successful at achieving financial sustainability. It was found that having a higher

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[54] *Id.*
[55] JONATHAN ADONGO & CHRISTOPHER STORK, FACTORS INFLUENCING THE FINANCIAL SUSTAINABILITY OF SELECTED MICROFINANCE INSTITUTIONS IN NAMIBIA, 19, 23 (Oct. 2005), *available at* https://www.afdb.org/fileadmin/uploads/afdb/Documents/Knowledge/25040371-EN-AEC-JADONGO.PDF.
[56] *Id.* at 25.
[57] *Id.* at 26.
[58] Bayeh Asnakew Kinde, *Finanial Sustainabiltiy of Microfinance Insitutions (MFIs) in Ethiopia*, 4. EUR. J. OF BUS. & MGMT. 1, 7 (2012), http://pakacademicsearch.com/pdf-files/ech/517/1-10%20Vol%204,%20No%2015%20(2012).pdf.

average loan size is better for profitability since larger loans means higher cost efficiency.[59] While some argue that this means microfinance institutions are drifting from their mission of reaching the poorest clients, others argue that a larger average loan size could just mean the MFI is matured with many repeat borrowers.[60] Kinde also found that having fewer donations helps with financial sustainability, which actually opposes what Adongo and Stork have said in their findings.[61] Kinde's reasoning is that donated equity helps microfinance institutions until they reach a certain point but it does not guarantee their sustainability.[62] Capital structure and staff productivity did not affect financial sustainability.[63]

These studies from other developing nations give us an idea of what kinds of factors impact financial sustainability of microfinance institutions. The legal form of institutions in India is also a factor worth studying. Whether a company is a society, a trust, a Section 25, a cooperative, or an NBFC has an impact on its financial sustainability, and therefore its ability to provide life-changing financial services.

The reason financial sustainability is so important is because it dictates how long a microfinance institution will be able to operate and therefore how long it will be helping society's poor. Another metric that is crucial in rating the effectiveness of microfinance institutions is client outreach, or how many people each institution is serving. Measuring financial sustainability and client outreach together will give us a vivid picture of how effective each legal form of microfinance institutions is.

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[59] *Id.* at 7.
[60] RICHARD ROSENBERG, MEASURING RESULTS OF MICROFINANCE INSTITUTIONS 5 (2009), https://www.cgap.org/sites/default/files/CGAP-Technical-Guide-Measuring-Results-of-Microfinance-Institutions-Minimum-Indicators-That-Donors-and-Investors-Should-Track-Jul-2009.pdf
[61] Kinde, *supra* note 58, at 8.
[62] *Id.*
[63] *Id.*

Chapter 2

Various Laws Govern Microfinance Institutions in India

To get a complete understating about the relationship between financial sustainability, client outreach, and reducing poverty, it is important to understand the differences of each form granted by the laws that set up the institutions. There are several different laws that allow the registration and formation of microfinance institutions in India. There are multiple laws, including both federal and state, that may govern the formation of one type of microfinance form (see Table 1).

Table 1: Laws Governing Microfinance Formation

[64]	**Societies**	**Trusts**	**Section 25s**	**Cooperatives**	**NBFCs**
Statute	Societies Registration Act of 1860 (Federal)[65]	Indian Trusts Act of 1882 (Federal)[66] and other Public Trusts Act Like Bombay Public Trusts Act of 1950 (State)[67]	Section 25 of the Companies Act of 1956 (Federal)[68]	Cooperative Societies Act of 1912 and Various State Acts such as Delhi Cooperative Societies Act of 1972 (State)[69]	Companies Act of 1956 (Federal)[70] and Reserve Bank of India Act of 1934 (Federal)[71]
Authority	Registrar of Societies	Charity Commissioner	Registrar of Companies	Registrar of Cooperative Societies	Reserve Bank of India and Registrar of Companies
Board of Management	Governing Body or Managing Committee	Trustees	Board of Directors	Board of Directors	Board of Directors
Mode of Succession for Board	Usually elected by General Body	Usually by appointment	Usually elected by General Body	Elected by General Body or appointed by Registrar	Usually elected by shareholders

Source: Administrative Reforms Commission

[64] ADMINISTRATIVE REFORMS COMMISSION, SOCIAL CAPITAL: A SHARED DESTINY, at 27 (2008), available at http://arc.gov.in/9threport/ARC_9th_report.htm, and SA-DHAN CHALLENGES, *supra* note 121, at 15, 21, 26, 46.
[65] Societies Registration Act, No. 21 of 1860, INDIA CODE (2016), http://www.mca.gov.in/Ministry/actsbills/pdf/Societies_Registration_Act_1860.pdf
[66] Indian Trusts Act of 1882, INDIA CODE (2016), http://indiacode.nic.in/rspaging.asp?tfnm=188202 from https://india.gov.in/indian-trusts-act-1882-0
[67] Bombay Public Trusts Act of 1950 (1982), http://gujcourts.guj.nic.in/acts/bombay_public_trusts_act-guj.pdf from https://india.gov.in/bombay-public-trust-act-1950?page=2
[68] Companies Act, No 1 of 1956, INDIA CODE (2016), § 25, https://www.mca.gov.in/Ministry/pdf/Companies_Act_1956_13jun2011.pdf
[69]Delhi Cooperative Societies Act 1972, from http://delhi.gov.in/wps/wcm/connect/doit_rcs/RCS/Home/Acts+and+Rules/The+Delhi+Cooperative+Societies+Act+1972/Chapter+1
[70] Companies Act, No 1 of 1956, INDIA CODE (2016), https://www.mca.gov.in/Ministry/pdf/Companies_Act_1956_13jun2011.pdf
[71] Reserve Bank of India Act of 1934, INDIA CODE (2009). https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/RBIAM_230609.pdf

Societies Registration Act, 1860

The Societies Registration Act of 1860 was formed while the British still occupied India. Modeled after the English Literary and Scientific Institutions Act of 1854, the law was passed to encourage activities benefitting society and to promote the formation of formal groups carrying out these activities.[72] The act helped bring like-minded people together so they could have a well-defined purpose, gain legal standing, raise sufficient funds, and allow the colonial government to keep a watch on them.[73] The Societies Registration Act allowed for the registration of literary, scientific, and charitable organizations as societies.[74] The exact wording of the relevant part of the act is as follows:

> "20. The following societies may be registered under this Act:
>
> Charitable societies, societies established for the promotion of science, literature, or the fine arts, for instruction, the diffusion of useful knowledge, the diffusion of political education, the foundation or maintenance of libraries or reading rooms for general use among the members or open to the public, or public museums and galleries of painting and other works or art, collections of natural history, mechanical and philosophical inventions, instruments, or designs."[75]

Microfinance institutions operating as societies would be classified as a charitable organizations, as they do not keep the profits from their operations.

States later went on to create amendments to the act to broaden the types of companies that can register as a society to any non-profit organizations that are development and empowerment-oriented such as cultural and literacy societies, professional associations, and educational, medical, and scientific

[72] 2ND ADMINISTRATIVE REFORMS COMMISSION, SOCIAL CAPITAL : A SHARED DESTINY, at 17 (2008), available at http://arc.gov.in/9threport/ARC_9th_report.htm

[73] Societies Registration Act, No. 21 of 1860, INDIA CODE (2016), http://www.vakilno1.com/bareacts/societyregact/societyregact.html (explaining history), and 2ND ADMINISTRATIVE REFORMS COMMISSION, SOCIAL CAPITAL: A SHARED DESTINY, at 18 (2008).

[74] Sidddhartha Sen, *Defining the Nonprofit Sector: India*, at 17 (1993).

[75] Societies Registration Act, No. 21 of 1860, INDIA CODE (2016), http://www.mca.gov.in/Ministry/actsbills/pdf/Societies_Registration_Act_1860.pdf

institutions.[76] This broader definition of the society allows for easier creation and thus explains the popularity of the legal form. According to the act, an organization needs seven people who subscribe to a Memorandum of Association to form the society.[77] They must also file with the Registrar of Societies to ensure rules are met and submit a list of management after each annual meeting.[78] Any person who would like to help the society pursue its objectives can join, and the societies may charge a fee if they so wish.[79] This feature is way to get many members of the community involved and therefore makes sure those who want to help have a voice. These start-up requirements are not very demanding, leading to the creation of more societies and therefore the spreading of financial inclusion.

Societies have a unique democratic organizational nature that comes from a periodical election of its governing body.[80] In addition, there is some flexibility given by the Societies Act of 1860 that allows the societies themselves to change some rules internally.[81] This flexibility is a positive for the communities that they serve, making societies more attractive to consumers.

Today, it is debated whether or not society members can be paid salaries; it is accepted in most states now, but not all.[82] The payment of members is another feature leading to the popularity of societies as choice of legal form, along with the easiness to form one. Popularity of the legal form ultimately leads to more creation and therefore the spreading of more services, so the easier to form the better.

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[76] Sen, *supra* note74, at 18.
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*

Indian Trusts Act of 1882

The Indian Trusts Act of 1882 is not a law for forming trusts, but rather for governing them.[83] More specifically, the act is for governing private trusts, as opposed to public trusts.[84] The act was passed to define the law regarding these private trusts.[85] As seen with the Societies Registration Act, the Indian Trusts Act came about during British rule in India.

According to the law, "A 'trust' is an obligation annexed to the ownership of property, and arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and the owner," and " A trust may be created for any lawful purpose."[86] Most trusts that are formed are for religious, charitable, communal, and educational purposes.[87]

A trust requires trustees to manage the trust as well as to assume full liability for a breach of trust.[88] The private property and assets of trustees are at risk, and they cannot withdraw their responsibilities unless they resign or retire.[89] This feature makes trusts less popular for the public and can decrease overall client outreach. Trustees cannot gain personal benefit from the trust, but can receive a management fee for overseeing operations of the trust.[90] Trusts receive almost the same status as societies in regards to income tax, through the Income Tax Act of 1961[91]

The Indian Trusts Act has a handful of attractive features: a flexible structure and minimal government interference, no required number of trustees, and a simple process to create the legal entity.[92] Some features that may cause problems include: 1) trustees are not allowed to enjoy the

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[83] *Id.*
[84] *Id.*
[85] Indian Trusts Act of 1882, INDIA CODE (2016), http://dateyvs.com/laws1/general-laws/indian-trusts-act-1882/ (explaining history)
[86] Indian Trusts Act of 1882, INDIA CODE (2016), http://indiacode.nic.in/rspaging.asp?tfnm=188202 from https://india.gov.in/indian-trusts-act-1882-0
[87] Sen, *supra* note74, at 19.
[88] *Id.*
[89] *Id.*
[90] *Id.*
[91] *Id.*
[92] *Id.* at 20.

benefits of the trust, so there are problems when they are part of the staff, 2) the organizational structure is somewhat closed and does not allow the removal of appointed members, and 3) trustees are liable for any breaches, so they must be extra careful.[93] Trusts are not too popular due to their circumstantial creations, leaving little room on how the legal form can be improved for clients.

Bombay Public Trusts Act of 1950

The Bombay Public Trust Act of 1950 is a law that is applicable to the two states of Maharashtra and Gujarat.[94] It is an example of a state law made to fill a gap in federal law, since the Indian Trusts Act only applies to private trusts. The act defines public trusts: "'public trust' means an express or constructive trust for either a public religious or charitable purpose or both and includes a temple, a math, a wakf, 1[church, synagogue, agiary or other place of public religious worship] 2[a dharmada] or any other religious or charitable endowment and a society formed either for a religious or charitable purpose or for both and registered under the Societies Registration Act, 1860."[95] A public trust benefits the society at large, while a private trust's beneficiaries are known and certain.[96]

In both Maharashtra and Gujarat, a society that is registered using the Societies Registration Act must also register as a trust; therefore, the procedure is quite bureaucratic, and trusts under this law lose many of the benefits of the Indian Trusts Act of 1882.[97] There is more government interference in terms of regulation and there are more requirements for formation of the entity. Nonetheless, forming a trust is still very simple, and there is plenty of autonomy in running a trust compared to other legal forms.[98]

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93 *Id.*
94 *Id.*
95 Maharashtra Public Trusts Act, Bombay Act No. 29 of 1950, at 5 (2016), http://bombayhighcourt.nic.in/libweb/acts/1950.29.pdf (last visited Mar. 2, 2017).
96 Bombay Charted Accountants' Society (BCA), *FAQ on the Maharastra Public Trusts Act, 1950*, https://www.bcasonline.org/Referencer2015-16/Other%20Laws/faq_on_the_bpt_act_1950.html
97 Sen, *supra* note74, at 20.
98 BCA, *supra* note 96.

Section 25 of the Companies Act of 1956

The Companies Act of 1956 was intended primarily for use by profit making companies, as we will see with NBFCs; however, Section 25 of the Companies Act can be used to form a non-profit company.[99] From the act itself:

> "25(1) Where it is proved to the satisfaction of the Central Government that an association: Is about to be formed as a limited company for promoting commerce, art, science, religion, charity or any other useful object, Intends to apply its profits, if any, or other income in promoting its objects, and to prohibit the payment of any dividend to its members, The Central Government may, by license, direct that the association may be registered as a company with limited liability, without addition to its name of the word "Limited" or the words 'Private Limited'."[100]

To obtain the status of a nonprofit under Section 25, a company must meet three general requirements: 1) possess a Memorandum of Association that makes the company clearly nonprofit, 2) the income of the company must be applied to charitable objectives and 3) members cannot receive dividends or profits.[101] Managers can be reimbursed for management but cannot take any profits, thus making the employing of staff difficult.[102] It is harder for companies to grow very large under this structure due to difficulty staffing. The Companies Act is more bureaucratic than the other acts we have seen so far and requires significant amounts of reporting.[103] Many of the benefits of the Section 25 form are available with other legal forms, without the regulations and reporting standards of the Companies Act. The Section 25 Company's ability to reach the poor can often be reduced due to staffing issues and regulations.

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[99] Sen, *supra* note 74, at 22.
[100] Companies Act, No 1 of 1956, INDIA CODE (2016), § 25, https://www.mca.gov.in/Ministry/pdf/Companies_Act_1956_13jun2011.pdf
[101] Sen, *supra* note 74, at 22.
[102] *Id.*
[103] *Id.*

Delhi Cooperative Societies Act of 1972

Cooperatives are typically formed using modified state laws of the Cooperative Act of 1904. Governments have more control of cooperatives than the other legal forms we have seen thus far, as we will see with the registrar's ability to conduct elections, audit accounts, nominate officials, and conduct enquiries.[104]

For this analysis, the Delhi Cooperative Societies Act of 1972 will be examined since it exemplifies provisions that have been adopted in several states. [105] An organization that promotes the economic interests of its members may be formed as a cooperative as long as adheres to the cooperative principles.[106]

One key principle is voluntary membership: membership should be available to all who will accept it, regardless of social, political, or religious background and race.[107] This allows for lots of community involvement with cooperatives. Another principle, the democratic system principle, says that administrators are elected and all members are allowed to participate in the process.[108] Democracy insures that the community's voices are being heard. The equitable distribution principle states that all profits or losses should be shared equally among all members.[109] The ability to make profits from cooperatives makes it more attractive to members looking to benefit themselves financially.

To form a cooperative, ten families need to come together and apply.[110] Cooperatives are managed by a general body, and are required to hold general meetings and regular elections of committees.[111] Law requires annual auditing and accounting.[112] It is possible to split cooperative societies into separate societies through the transfer of assets and liabilities with approval of its members, or the

[104] *Id.* at 20.
[105] *Id.*
[106] *Id.*
[107] *Id.*
[108] *Id.*
[109] *Id.*
[110] *Id.* at 21.
[111] *Id.*
[112] *Id.*

Registrar can divide and reorganize the cooperative in public interest.[113] Other powers of the Registrar include the right to supersede elected committees, call for new elections, and appoint administrators directly to the committee of a cooperative.[114] Lastly, cooperatives cannot provide loans to anyone besides members.[115] This severely limits the outreach of cooperatives, even though anyone can join a cooperative. Nonetheless, the profits and the exclusive access to services are a benefit to members.

The large disadvantage that comes with cooperatives is the amount of control the government has through the Registrar.[116] The government may not know what is in the best interest of the cooperative or the community; furthermore, the government can misuse the power it has on cooperatives during election cycles to gain votes and fund campaigns.[117] Cooperatives are not large in number, and those that exist can only serve a limited number of clients. This form is not capable of expanding rapidly to help others gain financial inclusion since only members may use the services.

Companies Act of 1956

The Companies Act of 1956 is the primary law that is used to register NBFCs, but does not necessarily govern them. The act, largely following the English Companies Act of 1948, was used to introduce certain changes from the Companies Act of 1913. The act of 1956 cleared up the duties of the companies and also allowed them to be formed through registration.[118]

To become an NBFC, there are two requirements a company must meet: First, it must obtain a certificate of registration from the Reserve Bank of India. In addition, it should have minimum net owned funds of 20 million rupees (Only applicable to companies that started business after April 21, 1999).[119]

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[113] *Id.*
[114] *Id.*
[115] *Id.*
[116] *Id.*
[117] *Id.*
[118] The Companies Act of 2013, INDIA CODE (2016), https://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf
[119] *Id.* at 27.

To obtain a certificate of registration from the Reserve Bank of India, a company must be registered under the Companies Act of 1956 and also meet the minimum net owned funds requirement of 20 million rupees.[120] Net owned funds are equal to shareholder's equity plus any internally generated reserves.

Reserve Bank of India Act of 1934

The Reserve Bank of India Act of 1934 sets most of the regulations for NBFCs.[121] The Reserve Bank of India Act was passed in 1934 to form the Reserve Bank of India and to supervise banks and banking firms in India.[122] The act defines an NBFC as any company that partakes in lending, receiving of deposits (as the main business), acquisition of shares, stocks, or other securities, hire-purchase or leasing, insurance, chit funds, and lotteries.[123] Therefore, any for-profit company engaging in microfinance would be considered an NBFC and would be regulated as such.[124]

NBFCs can generally be broken up into NBFCs that accept public deposits and NBFCs that do not, with NBFCs that do take public deposits being subject to more rigorous (prudential) compliance rules.[125] All NBFCs must submit returns to the RBI within given timeframes. For instance, audited balance sheets are due within fifteen days of the general meeting, an auditor's report and the attached certificate given to the Board of Directors are due along with the balance sheet, semi-annual returns are due within three months of the half-year ending date, and information on the company's financial position is due based on a schedule given by the RBI.[126]

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[120] *Id.*
[121] SA-DHAN, EXISTING LEGAL AND REGULATORY FRAMEWORK FOR THE MICROFINANCE INSTITUTIONS IN INDIA : CHALLENGES AND IMPLICATIONS 26-27 (2006) (hereinafter, SA-DHAN CHALLENGES)
[122] https://en.wikipedia.org/wiki/Reserve_Bank_of_India_Act,_1934
[123] SA-DHAN CHALLENGES, *supra* note 121, at 25.
[124] *Id.*
[125] *Id.*
[126] *Id.* at 31.

In addition to the requirements above, there are prudential norms for all NBFCs that are summarized below. If a company does not accept public deposits they are exempt from the capital adequacy norm and the concentration norm.[127]

Regarding capital adequacy, Every NBFC must maintain a capital adequacy ratio of 15%[128], which is its (Tier I assets + Tier II assets) / Risk Weighted Assets.[129] Tier I capital can be define as capital that is permanently and easily available to cushion losses, while Tier II capital is capital that is available to cushion losses only when a bank stops operating.[130] Regarding its investments, NBFCs can invest at most 10% of their net owned funds in land and buildings, and 20% of their net owned funds in unquoted shares of other companies.[131] Regarding accounting standards, NBFCs must comply with standards dealing with income recognition, income from investments, asset classification, and disclosure in the balance sheet.[132]

On top of prudential norms, there are regulations for NBFCs that accept public deposits in order to maintain the confidence of the public. NBFCs must get an investment grade rating from one of the credit rating agencies at least once a year.[133]

With all the aforementioned regulations that NBFCs must undergo, there are certain advantages and disadvantages. Advantages include higher investor confidence, being an attractive option for social investors, easier potential up scaling of operations, and limited regulations if the NBFC does not accept deposits.[134] The disadvantages of NBFCs generally include the minimum capital requirement, inability to mobilize deposits without meeting strict requirements, restrictions on venture capital and foreign direct investment, and of course the large amounts of oversight and regulation.[135]

[127] *Id.* at 34.
[128] *Id.* at 33.
[129] Investopedia, *Capital Adequacy Ratio*, http://www.investopedia.com/terms/c/capitaladequacyratio.asp (last accessed: March 2, 2017)
[130] *Id.*
[131] *Id.*
[132] *Id.*
[133] *Id.*
[134] *Id.* at 39.
[135] *Id.*

Chapter 3

Examples of the Affects of Legal Form on Particular Microfinance Institutions

How do the legal forms play out in the real world? Following are examples of each legal form with characteristics that describe their performance. The society microfinance institution described is Bal Mahila Vikas Samiti (VAMA), the trust is PRAYAS (Organization for Sustainable Development), the Section 25 Company is Bharatiya Micro Credit, the cooperative is the Saath Savings and Credit Co Op Society Ltd., and the NBFC is M Power Microfinance.

Qualitative Analysis of the Institutions

Bal Mahila Vikas Samiti (VAMA): This society was established in 1988 by a team of social workers in Madhya Pradesh, India.[136] While VAMA started many of its social programs in 1988, its microfinance division was only started in 2006.[137] As a non-profit, all income is invested back into the company to accomplish their mission. The organization truly cares about equality in society, and not just poverty, which we can see in the mission statement. The mission statement of the institution is "To establish an egalitarian society based on rights so that the poor, marginalized, and dalits – especially women, have equal participation in all spheres."[138] VAMA currently employs 51 people, and has reached 18,128 households, 148 villages, and 47 urban slums with their projects and programs. [139]

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[136] VAMA INDIA, ANNUAL REPORT 2014-2015, at 4, available at http://www.vamaindia.org/custom/pixpage/docs/annual-report-2014-15.pdf.
[137] *Id*, at 19.
[138] *Id*, at 3.
[139] *Id*.

Through its microfinance unit, VAMA encourages formation of SHG's, and has already helped form 1869 of them.[140] They currently help 300 SHG's through the government's credit linkage program.[141] Microfinance organizations like VAMA will often give out loans only for special purposes; VAMA mostly loans specifically for dairy, agriculture, sanitation and maintenance, and microenterprises and services.[142] In terms of outreach, VAMA has given loans to 19,482 people[143], and currently serves 995 groups, 2069 active clients, and has 5190 members.[144] VAMA's microfinance unit loan portfolio is 223, 300, 000 rupees, with an average loan size of 7514 rupees as of March 2015.[145]

PRAYAS (Organization for Sustainable Development): PRAYAS, a trust organization, was registered in 1997 under the Trust Registration Act of 1950 by founder Bhadresh Rawal.[146] Rawal envisioned a society where there is greater economic opportunity, accessible financial services, and awareness of rights and duties.[147] As a non-profit, any profits are invested back into the firm to continue attaining its objectives. Since PRAYAS is a trust, its funds and property come from a trustor and are managed by the trustees. The organization, operating in Madhya Pradesh Gujarat and Assam, has 3 main objectives:

1. To establish a sound and professional micro finance program to provide access to financial services primarily to low income clients who presently lack it.

2. To strengthen vulnerable sections of the society by making them aware of their rights and empowering them to assert these rights to protect themselves against any form of exploitation.

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[140] *Id, at 16.*
[141] *Id.*
[142] *Id*, at 21.
[143] *Id.*
[144] *Id*, at 3.
[145] *Id.*
[146] PRAYAS, *Inception of PRAYAS*, http://www.prayas4development.org/orgdetails.htm (last accessed March 2, 2017)
[147] PRAYAS ANNUAL REPORT, *supra* note 5, at 5.

3. To carry out other social interventions such as an Education, Health, disaster management, livelihood promotion, community organization, etc. which can create social benefits for the community.[148]

PRAYAS, like VAMA, engages in other programs besides microfinance; some of these programs include natural resource management, human rights advocacy programs, women empowerment groups, and AIDS awareness and prevention programs.[149]

Like plenty of other microfinance organizations, PRAYAS strives to implement the SHG-Bank linkage program in order to help local groups get access to banks, and it also directly lends to SHGs through its own microfinance program.[150] PRAYAS has given out 16,676 loans to 17,219 borrowers in 92 villages and 47 urban locations since the start of the microfinance program in 2006.[151] They offer four types of loan products: JLG Monthly and SHG Monthly (for things like agriculture, livestock, health, and business), housing loans (for reparation and construction of houses), and water and sanitation loans.[152] Of the 17,219 borrowers PRAYAS currently reaches, 10,219 borrow from JLG Monthly, 6,685 from SHG Monthly, and 315 from water and sanitation loans.[153] The total outstanding loan amount was 162,100,000 rupees and the average loan size was 9,413 rupees as of March 2015.[154]

Bharatiya Micro Credit (BMC): This Section 25 Company was registered in 2007 under Section 25 of the Companies Act of 1956.[155] BMC primarily does business in the state of Uttar Pradesh, but has slowly begun expanding to states like Madhya Pradesh as well as the New Delhi area.[156] As a

[148] PRAYAS, *What is Prayas?*, http://www.prayas4development.org/index.htm (last accessed March 2, 2017)
[149] PRAYAS, *Program Description*, http://www.prayas4development.org/programs.htm (last accessed March 2, 2017)
[150] PRAYAS ANNUAL REPORT, *supra* note 5, at 16.
[151] *Id*, at 15 and 18.
[152] *Id*, at 18.
[153] *Id*, at 17.
[154] *Id*, at 18.
[155] Bharatiya Micro Credit, *About Us*, http://bmcindia.co/aboutus.php (last accessed March 2, 2017)
[156] *Id.*

Section 25 Company, BMC is a non-profit company meaning it cannot take deposits either.[157] Unlike VAMA and PRAYAS, Bharatiya Micro Credit first started out as a microfinance institution, and is now looking to facilitate additional services in the areas of health and education by partnering with other organizations.[158] BMC's main focus is to "enhance the income of households and to improve the status of women in the society"[159] Loans that they give out through their 54 branches are typically used for income generating activities like small shops, small trade, animal husbandry, and rickshaw services.[160]

As of March 2015, Bharatiya Micro Credit employed 249 people to help them achieve their goals.[161] In terms of outreach, they had 68,959 clients, 91,805 members, and 7,105 groups that they served. Their cumulative disbursement of funds was 780,553,000 rupees, and dividing by the 68,959 clients gives them an average loan size of 11,319 rupees.[162]

The Saath Savings and Credit Co Op Society Ltd: Saath is a cooperative, registered under the Gujarat Cooperative Societies Act of 1961.[163] The organization started out as Saath Charitable Trust Ahmedabad, and then in 2010 became registered as The Saath Savings & Credit Cooperative Society Ltd with the combination of several different cooperatives.[164] The vision of the organization is "To build a sustainable community-based organization to provide financial services to the socially marginalized and economically deprived sections of society, in order to eventually reduce poverty and bring prosperity."[165] They will accomplish this vision through concrete objectives such as developing savings habits in their members, providing loans at affordable interest rates, providing affordable insurance, etc. [166] As a

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157 *Id.*
158 *Id.*
159 *Id.*
160 *Id.*
161 Bharatiya Micro Credit, *Operations,* at http://bmcindia.co/operation.php (last accessed March 2, 2017)
162 *Id.*
163 SAATH COOPERATIVE, ANNUAL REPORT 2014-2015, at 59, available at http://saathcooperative.org/images/Saath%20Annual%20Report_2014-15.pdf (hereinafter Saath Annual Report)
164 *Id.*
165 *Id.*
166 *Id.*

cooperative, all profits and losses are shared between members. Additionally, services can only be accessed by members.

Saath offers loans for several different reasons: consumption loans for health, education, and household expenditures, productive loans for establishing micro-enterprises, asset creation loans for debt redemption, house repairs, and asset purchases, individual loans for businesses[167].

Saath employs 72 people total, which are spread out through their 10 branches.[168] Saath can take deposits since it is a cooperative, unlike some of the other aforementioned legal forms.[169] As of March 2015, its total deposits were 87,916,889 rupees. Saath had 19,992 members, served 1,313 JLGs, and had issued 5,907 loans outstanding[170]. The amount of cumulatively disbursed loans was 90,912,397 rupees, and they had an average loan size of 15,390 rupees.[171]

M Power Micro Finance Pvt Ltd.: M Power is registered with the Reserve Bank of India as a Non Banking Finance Company in Maharashtra.[172] As an NBFC, M Power is a for-profit company that does not hold deposits. Any profits can be reinvested into the company or paid out to investors as dividends. They have ability to raise capital by issuing shares of their company. M Power's mission is "True to the tagline 'Nurture Dreams, Transform Lives', M Power Micro finance would strive to Nurture the many dreams of the Bottom of Pyramid (BOP) segment and try and address the challenges to transform the lives of the poor at large."[173]

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[167] *Id*, at 67.
[168] Saath Cooperative, *Branches*, http://saathcooperative.org/branches.aspx (last accessed March 2, 2017)
[169] Saath Cooperative, *Deposits*, http://saathcooperative.org/deposits.aspx (last accessed March 2, 2017)
[170] Saath Cooperative, *Statistics*, http://saathcooperative.org/statistics.aspx (last accessed March 2, 2017)
[171] SAATH ANNUAL REPORT, *supra* note 163, at 62, 66
[172] M Power Microfinance, *About* Us, http://mpowermicro.com/about-us/ (last accessed March 2, 2017)
[173] M Power Microfinance, http://mpowermicro.com/ (last accessed March 2, 2017)

M Power gives out loans for both rural/agricultural purposes, as well as business purposes.[174] As of March 2015, M Power had served 67,398 clients through its 21 branches, and had a total disbursement of 754,500,000 rupees.[175] The average loan size was 11,194 rupees.

Quantitative Results and Analysis

To compare the selected microfinance institutions on the basis of outreach and financial sustainability, this thesis computes the number of clients, average loan size and returns figures. The metrics will be explained in detail in the next chapter. Generally, a microfinance institution needs to strike a balance between number of clients served and their returns on assets and equity.

Table 2: Quantitative Comparison of Selected Microfinance Institutions

	Bal Mahila Vikas Samiti (Society)[176]	PRAYAS (Trust)[177]	Bharatiya Micro Credit (Section 25)[178]	Saath Savings and Credit Cooperative (Cooperative)[179]	M Power Microfinance (NBFC)[180]
Clients Served	19,482	17,219	68,959	19,992	67,398
Avg. Loan Size	7,514	9,413	11,319	15,390	11,194
ROA	.88%	4.71%	3.19%	.36%	2.98%
ROE	2.22%	14.56%	13.06%	2.96%	10.50%

Sources: Bal-Mahila Vikas Samiti (VAMA), PRAYAS (Organization For Sustainable Development), Bharatiya Micro Credit, Saath Annual Report, and M Power Microfinance

[174] M Power Microfinance, *Operations*, http://mpowermicro.com/operations/ (last accessed March 2, 2017)
[175] M POWER MICROFINANCE, ANNUAL REPORT 2015-2016, at 6, available at http://mpower.webtastic.in/wp-content/uploads/2016/09/Annual-Report-2015-16.compressed.pdf
[176] BAL-MAHILA VIKAS SAMITI (VAMA), AUDIT REPORT 2014-2015, at 1-4, available at http://www.vamaindia.org/custom/pixpage/docs/audit-report-2014-15.pdf,
[177] PRAYAS (ORGANIZATION FOR SUSTAINABLE DEVELOPMENT), FINANCIAL REPORT FY 2015, 3 and 4, available at http://www.prayas4development.org/reports/PRAYAS%20mF%20Financial%20Report-FY-2014-15.pdf
[178] BHARATIYA MICRO CREDIT, FINANCIAL STATEMENTS 2014-2015, 4 and 5, available at http://bmcindia.co/images/audit/BMCFinancialStatement2014-15.pdf
[179] SAATH ANNUAL REPORT, *supra* note 163, at 73-74
[180] M POWER MICROFINANCE, FINANCIAL REPORT, 1, available at http://mpower.webtastic.in/wp-content/uploads/2016/09/Financial-Report-Mar-2016.pdf

Table 2 compares outreach and financial sustainability statistics for each of the selected microfinance institutions. Number of active clients and average loan size are used for measuring outreach, while return on assets and return on equity were calculated for each microfinance institution to compare financial sustainability.

These statistics represent just one company of each legal form and therefore differ from the legal form averages that will be discussed in the following chapter. These statistics are a case by case basis and are affected by variables that typically disappear when taking the average of a large group. Nonetheless, there are possible effects of the laws that show up in these statistics.

Looking at clients served, it is expected that M Power Microfinance has a larger outreach due to its ability to raise capital and therefore upscale operations. The Section 25 Company, Bharatiya Micro Credit, also has a large number of clients, potentially due to the fact that it is registered under the Companies Act and therefore can be seen as trustworthy to clients. There is a chance that Bharatiya Micro Credit would be even more successful registered as another legal form because they could either 1) reduce the amount of regulation they must go through, or 2) gain the ability to pay dividends and therefore gain investors and capital. Saath Savings and Credit Cooperative is only allowed serve members, so the number of clients is justified.

Looking at average loan size to measure depth of outreach, it seems that the society, Bal-Mahila Vikas Samiti serves the poorest of clients. The small loan size indicates that their borrowers would likely have trouble paying off larger amounts. Saath, the cooperative, has the largest average loan size of the study. They only offer services to members, so it is possible that they have wealthy member base compared to the clients that the other legal forms are serving.

For returns on assets and equity, PRAYAS, the trust, had the highest figures of the group. They were also above the industry averages that will be discussed in the next chapter. The society and the cooperative underperformed the industry average significantly, but were still positive and therefore sustainable.

Out of the selected microfinance institutions, all of them had positive returns. PRAYAS was very successful when considering financial sustainability, but did not serve nearly as many clients as Bharatiya or M Power.

The contest to see which legal form is the most effective in this case study is between the NBFC and the Section 25. The effects of economies of scale are shown through Bharatiya Micro Credit and M Power Microfinance. Bharatiya slightly edges out M Power in returns, but has also been incorporated for two more years, giving it more time to expand its business and increase efficiency. Looking at the compound annual growth rate of the microfinance institutions will provide us with a look into the past and also the future of these two institutions. The compound annual growth rates of clients served from March 2012 to December 2015 for these institutions are 136% for M Power and 133% for Bharatiya, meaning that M Power has been growing at a faster rate and will most likely continue to do so.[181] The December 2015 number of clients served was 88,371 for M Power (estimated) and 78,173 for Bharatiya, giving M Power a strong lead.[182] The ROE for M Power calculated at the end of March 2016 nearly doubled, up to 20.29%.[183] 2016 information for Bharatiya has not been published. While both of these institutions serve a large number of clients and have commendable ROA and ROE figures, M Power Microfinance stands out as the most successful given its growth rates and most recent financials.

Time plays a factor when comparing the individual microfinance institutions in a case study such as this one. In the next section, the industry as a whole will be analyzed, removing most of the time bias that comes with a head-to-head institutional case study.

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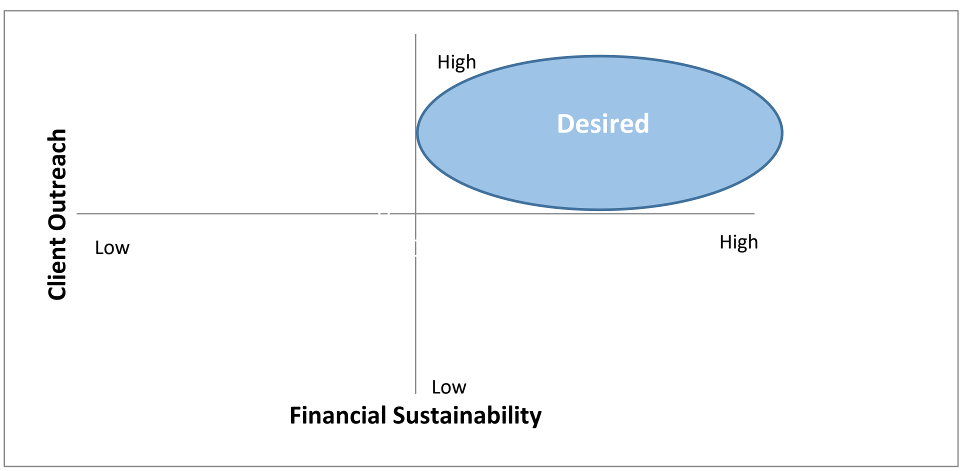
[181] M POWER MICROFINANCE ANNUAL REPORT, *supra* note 175, at 6 and Bharatiya Micro Credit, *supra* note 178.
[182] *Id.*
[183] *Id*, at 7.

Chapter 4

Choice of Legal Firm Dictates Financial Sustainability and Outreach Capabilities

Two of the most important metrics mentioned in the literature as defining effectiveness are client outreach and financial sustainability. Outreach has two components: breadth and depth. Breadth of outreach refers to how many clients are being served, while depth of outreach refers how poor the clients are.[184] In other words, how many people, cities, or states are the microfinance institutions able to reach based on its legal form? The second metric is financial self-sufficiency or financial sustainability. The operations of the microfinance institution must be sustainable so that it can continue providing service for longer periods, thus being more effective at reducing poverty. Ideally, a firm will have a strong balance between these two metrics. Being sustainable but not serving many clients, or serving many clients but not being sustainable both are undesired results since they do not help serve the most clients in the long run. The figure below illustrates where a successful institution would fall when measuring the two metrics together.

Figure 1: Desired Balance of Metrics



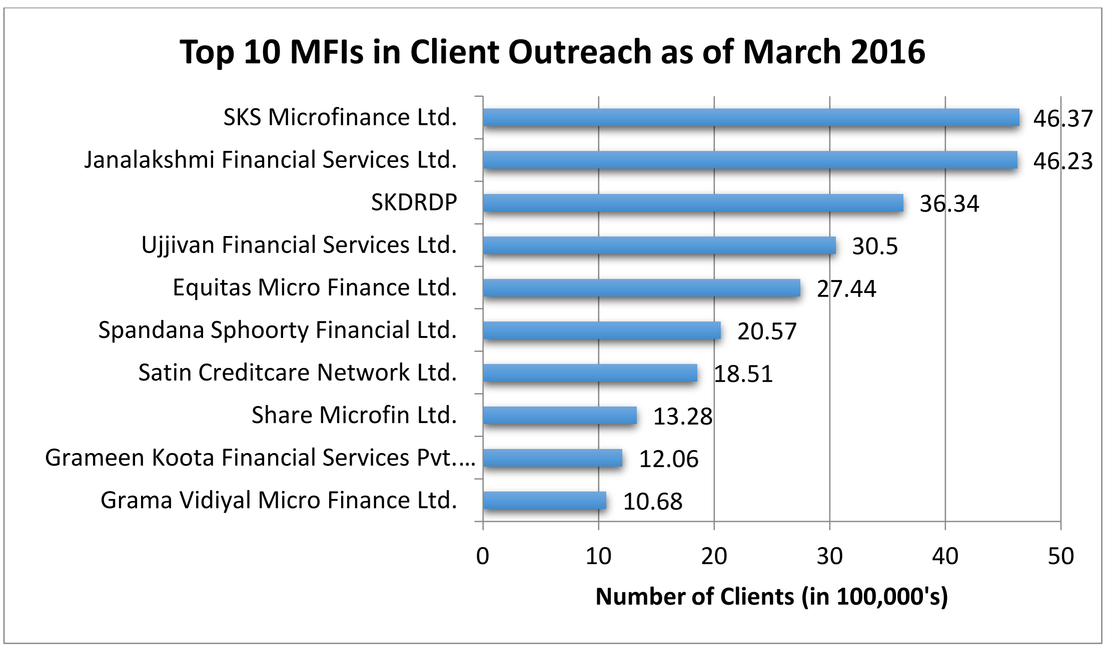
[184] ROSENBERG, *supra* note 60 , at 1.

Breadth of Outreach

A widely used metric in the industry for measuring breadth of outreach is simply the number of active clients or accounts at a given point in time.[185] The active number of clients or accounts is used as opposed to the cumulative numbers of clients and accounts to get rid of the bias towards institutions that offer short-term loans and not long-term loans.[186]

Statistics on the microfinance sector in India are compiled annually to give interested parties an update on the industry. The 2016 Bharat Microfinance Report has found that nine out of the top ten MFIs that have the most clients are NBFCs.[187] It has been that way for many years now, and can be attributed to legal form, availability of funds, business plan, and regulatory environment.[188] The only non-NBFC microfinance institution in the top ten in terms of outreach is SKDRDP, which is a trust.[189]

Figure 2: Top 10 Institutions in Client Outreach

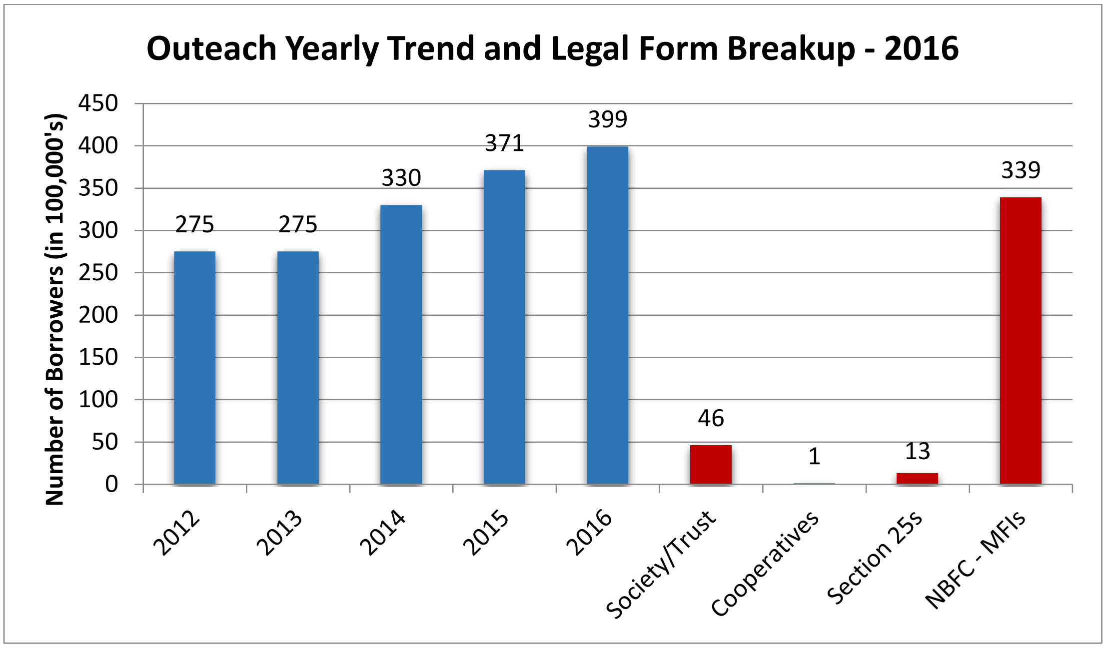


[190]

Source: Sa-Dhan

[185] *Id.* at 3.
[186] *Id.* at 3.
[187] SA-DHAN BHARAT REPORT, *supra* note 23, at 18.
[188] *Id.*
[189] Shri Kshethra Dharmasthala Rural Development Project (SKDRDP), *About SKDRDP*, http://www.skdrdpindia.org/content/about/about.html (last visited Mar. 2, 2017).
[190] SA-DHAN BHARAT REPORT, *supra* note 23, at 17.

Figure 3: Outreach by Year and Legal Form



[191]

Source: Sa-Dhan

Figure 3 shows the number of total borrowers from microfinance institutions throughout past years, and provides a breakdown of number of borrowers in 2016 by legal form. NBFCs dominate the category of outreach, serving 84.9% of all clients that use microfinance services as of March 2016. Furthermore, microfinance institutions with an outstanding portfolio size of over five billion rupees serve 85.4% of all clients that use microfinance services. The outreach of the microfinance sector is top heavy, with big firms serving most of the clients. It is also the case that most of the larger firms are NBFCs. Therefore, there is something about NBFCs that allow them to upscale operations easier than other legal forms.

First, NBFCs enjoy higher investor confidence than the other legal forms. MFIs are registered with the Reserve Bank of India and are recognized and regulated entities for carrying out microfinance

[191] SA-DHAN BHARAT REPORT, *supra* note 23, at 14.

operations.[192] Both the recognition and regulation aspect increase the perception of safety of NBFCs to institutional investors and banks, and therefore bring in more investment for NBFCs. Another reason for NBFC success is the fact that they are the most attractive option of all legal forms for social investors. The regulated structure required by law, the professional management required to meet those regulations, and the required disclosure of financial statements make social investors more willing to put their funds into an NBFC.[193] This access to capital, paired with the disciplined management of the NBFCs, make it easier to them to upscale operations. Being able to grow the business quickly certainly helps NBFCs reach more clients than the other legal forms.

Compared to NBFCs, the other legal forms encounter hindrances when trying to upscale operations. They have trouble getting investors to pour equity into their business for numerous reasons. Section 25s are prohibited from distributing dividends due to their non-profit designation, making them a poor choice for social investors.[194] It is also difficult for investors in Section 25's to exit since they must find another investor to sell to who is willing to give up dividends.[195] Both societies and trusts do not have systems for equity investment, making them unattractive to commercial investors.[196] Furthermore, there is less investor confidence and more perceived risk in societies and trusts due to the absence of professionalism.[197] Cooperatives are not seen as a trustworthy organizational form due to the fact they are either heavily regulated or not regulated at all, depending on the Registrar's involvement with that particular cooperative.[198] They will often engage in risky practices since they have the ability to, hurting their public image to investors.[199]

When it comes to outreach, NBFCs have a strong advantage due to the regulation required by the law. The disciplined management and financial disclosure requirements draw most of the social and

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[192] Prakash Singh, Understanding The Structure of Micro Finance Institutions in India and Suggesting a Regulatory Framework 119, at http://www.iibf.org.in/documents/reseach-report/Report-24.pdf.
[193] *Id.*
[194] *Id.*
[195] *Id.*
[196] *Id.*
[197] *Id.*
[198] SA-DHAN CHALLENGES, *supra* note121, at 50.
[199] *Id.*

institutional investors to their legal form. Other legal forms cannot guarantee the safety of investments or do not have the ability to take in equity investment by law, making them miss out on investor funds. The lack of access to this investor capital makes it harder for societies, trusts, Section 25's, and cooperatives to upscale operations and reach more clients.

Another matter affecting outreach is the easiness to register as a microfinance institution using the legal form. Some legal forms have stringent requirements that need to be met for registration, limiting the capabilities of smaller organizations. The following table outlines differences in registration between the several legal forms.

Table 3: Differences in Registration by Legal Form

[200]	**Societies**	**Trusts**	**Section 25s**	**Cooperatives**	**NBFCs**
Statute	Societies Registration Act of 1860	Indian Trusts Act of 1882 and other Public Trusts Act Like Bombay Public Trusts Act of 1950	Companies Act of 1956	Cooperative Societies Act of 1912 and Various State Acts such as The Delhi Cooperative Societies Act of 1972	Companies Act of 1956 and Reserve Bank of India Act of 1934
Number of People Needed to Register	Minimum of seven	Minimum of two trustees	Minimum of seven	Minimum of ten	N/A
Other requirements for registration	Memorandum of Association	Clear declaration of trust, certainty of subject matter and objects of the trust	Memorandum and Articles of Association, Copies of Financial Statements	Bye-laws and Enquiry Performa	Certificate of Registration from RBI, Net Owned Funds of 20 million rupees

Source: 2nd Administrative Reforms Commission and Sa-Dhan

[200] SOCIAL CAPITAL: A SHARED DESTINY, at 27 (2008), available at http://arc.gov.in/9threport/ARC_9th_report.htm, and SA-DHAN CHALLENGES, *supra* note121, at 15, 21, 26, 46.

Societies are the simplest microfinance legal form. They have very few requirements for start-up and are not heavily regulated after formation. Trusts are also not heavily regulated, but are not as popular since the funds or land must be given by a trustor to be started. Section 25s are not popular due to the fact that many of their benefits can be realized with a society or trust, which do not have to go through the regulation of The Companies Act. Cooperatives go through moderate to heavy regulation and can only serve the members; therefore, they are not a very popular form for microfinance institutions. Lastly, NBFCs undergo heavy regulation and difficult startup requirements; nevertheless, they are quite popular as they are seen as trustworthy and reliable. Microfinance institutions that wish to be seen as professional businesses strive to be NBFCs. The number of institutions across legal form as of 2016 was as follows: Societies – 78; NBFCs - 71; Section 25s – 29; Trusts – 19; and Cooperatives – 12.[201] Societies are the most popular, followed by NBFCs, giving them an edge in outreach.

Depth of Outreach

To measure depth of outreach, a ratio of outstanding loans/savings balance per client over gross national income per capita is used.[202] Average outstanding loan balance can be calculated as gross amount of loans or savings outstanding over number of active clients or accounts.[203] The lower the ratio, the poorer the clients are considered.

$$Metric\ for\ Depth\ of\ Outreach = \frac{Average\ Outstanding\ Balance}{GNI\ per\ capita}$$

$$Average\ Outstanding\ Balance = \frac{Gross\ amount\ of\ loans\ or\ savings\ outstanding}{Number\ of\ actie\ clients\ or\ accounts}$$

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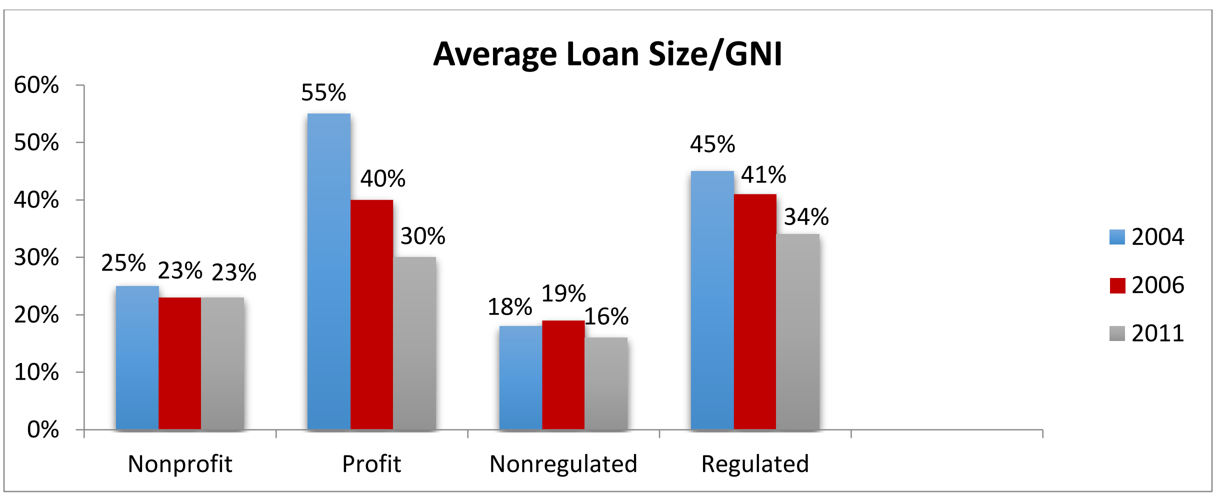
[201] SA-DHAN DIRECTORY, *supra* note20, at 6.
[202] ROSENBERG, *supra* note 60 , at 4.
[203] *Id.*

A study done in 2008 found that the average loan balance over GNI ratio for the Indian microfinance sector was 13.0%.[204] NBFCs had the highest ratio of all legal forms at 14.1%.[205] This ratio shows that NBFCs have higher average loan sizes than other legal forms, but it does not necessarily mean they do not reach the poorest communities with their services. While it is typically the more prosperous clients that would take out larger loan, there are situations where the poorer client base could have a higher average loan size. For example, most microfinance institutions offer larger loan sizes after the initial loan has been paid off.[206] In addition, as a microfinance institution matures, most clients are no longer first time buyers, so the average loan size increases.[207]

The figure below from CGAP shows us that average loan size tends to be higher in for-profit and regulated industries. NBFCs would be considered regulated and for-profit entities. Societies, trusts and Section 25's would be non-profit. Cooperatives could fall under non-profit or profit and non-regulated or regulated depending on which law is used.

Figure 4: Average Loan Size/GNI Ratio by Regulated and For-Profit Status



[208]

Source: CGAP

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[204] Singh, *supra* note194, at 113.
[205] *Id.*
[206] ROSENBERG, *supra* note 60, at 5.
[207] *Id.*
[208] CGAP, MICROCREDIT INTEREST RATES AND THEIR DETERMINANTS, at 17, from http://www.cgap.org/sites/default/files/Forum-Microcredit%20Interest%20Rates%20and%20Their%20Determinants-June-2013.pdf

There is a positive correlation between average loan size and the offering of savings services, found by CGAP.[209] Therefore, a firm that offers savings services to its clients generally has a larger average loan size. Given that NBFCs have the ability to take deposits if they follow certain requirements, it makes sense they would have a higher average loan size to GNI ratio. Unincorporated companies such as societies and trusts are not allowed to collect savings by law.[210] Sections 25s are also forbidden to mobilize deposits by law, but cooperatives can accept deposits.[211] The ability regarding whether the legal form can accept deposits directly affects the average loan size, and therefore depth of outreach.

Financial Sustainability

The most common metrics used for measuring financial sustainability of a microfinance institution are return on assets, return on equity, a ratio for financial self-sufficiency, and an adjusted return on assets ratio. The first two ratios will be used for this analysis.

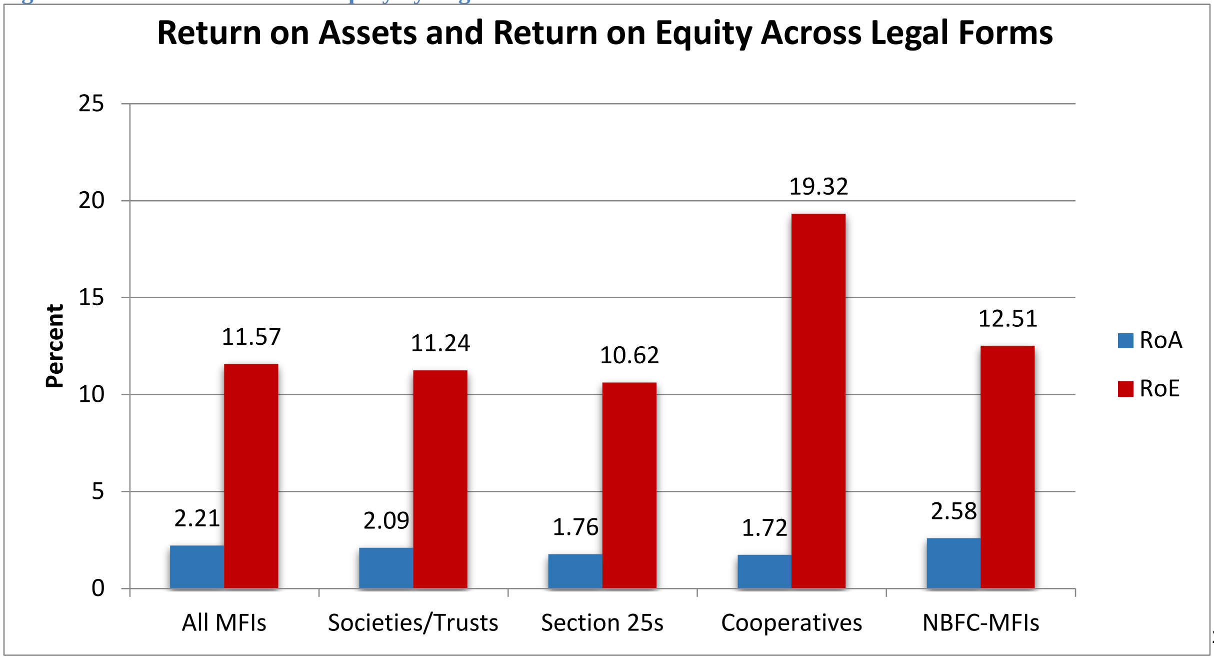
$$ROA = \frac{After\text{-}Tax\ Profits}{Starting\ (or\ period\text{-}average) assets}$$

$$ROE = \frac{After\text{-}Tax\ Profits}{Starting\ (or\ period\text{-}average) equity}$$

When looking at the profitability ratios compiled in the 2016 Bharat Microfinance Report, NBFCs have the highest ROA at 2.58 and the second highest ROE at 12.51. Cooperatives have the highest ROE at 19.32, but the lowest ROA at 1.72. Societies/Trusts have an ROA and an ROE of 2.09 and 11.24 respectively.

[209] *Id.*
[210] Singh, *supra* note 194, at 118.
[211] *Id.*

Figure 5: Return on Assets and Equity by Legal Form



[212]

Source: Sa-Dhan

A partial explanation to the success of the NBFC in profitability ratios is there success in keeping operating costs down. The operating expense ratio for NBFCs was 8.5 in March of 2016.[213] This is the lowest of all legal forms, followed by Section 25's at 9.3, and an industry average of 10.2.[214] The operating expense ratio does not fully explain ROA and ROE since Section 25's had the second lowest operating expense ratio, yet low profitability ratios.

The operating expense ratios, and costs overall can be explained by a few different factors. Lower costs for NBFCs can be related back to their ability to scale up operations quickly. Larger microfinance institutions experience economies of scale benefits; particularly, cost per borrower will decrease, and transaction cost will decrease as a firm gets larger.[215] Smaller firms will have higher costs. Furthermore, since NBFCs are in the industry to make a profit, their business acumen may be better than the managers of non-profits and cooperatives.

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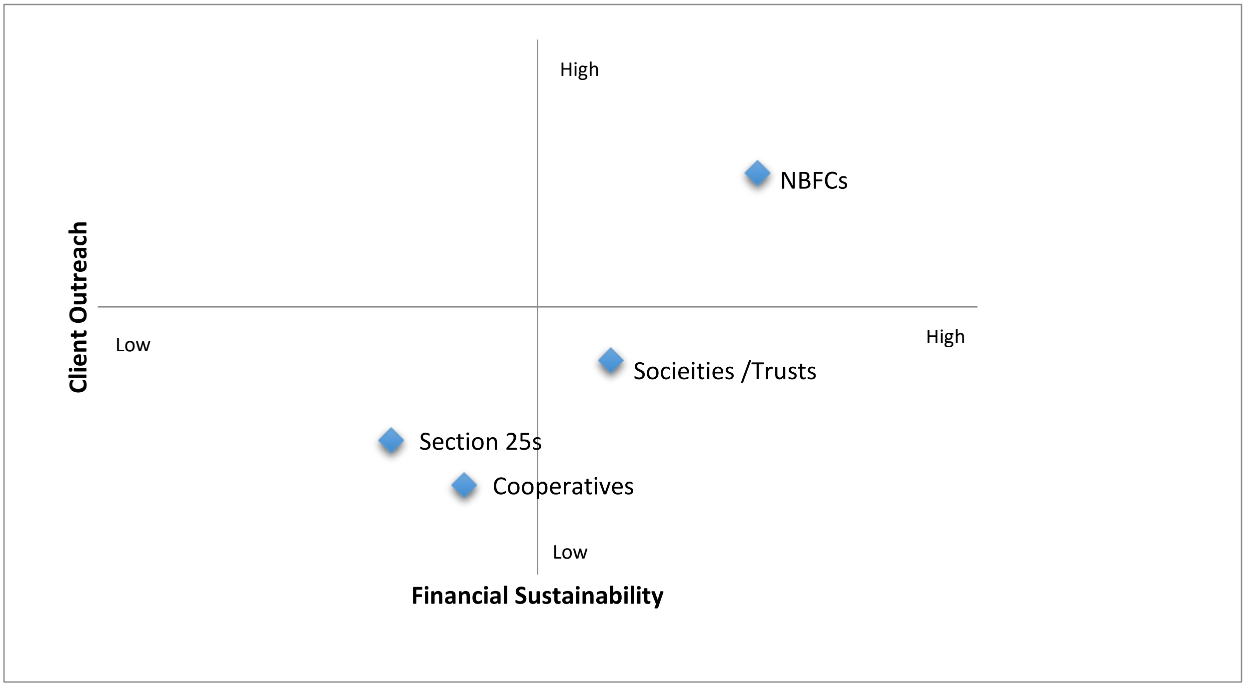
[212] SA-DHAN BHARAT REPORT, *supra* note 23, at 43.
[213] *Id*, at 36.
[214] *Id.*
[215] Singh, *supra* note 194, at 125.

In addition to operating costs, one would think that taxes can play a role in financial viability of an institution. As it turns out, though, there is no large correlation between taxes and ROA and ROE. NBFCs are taxed as a for-profit organization, yet have higher returns than the non-profits. Societies, trusts, and Section 25s are mostly exempt from tax due to their charitable nature, yet were outperformed by NBFCs in financial sustainability metrics.[216] It seems that other benefits such as the professional management and economies of scale outweigh the impact of taxes for NBFCs.

Summary

The legal forms can be represented as points on the figure that was earlier used to define successful institutions.

Figure 6: Placement of Legal Forms by Desired Balance of Metrics



[216] *Id* at 117.

According to the important metrics, it appears that NBFCs are the desirable model for microfinance institutions in their mission to help the poor. NBFCs are the most sustainable microfinance institution and they also reach the most clients through breadth of outreach. Their ability to raise equity capital plays a significant role in their ability to upscale operations, which in turn increases both outreach and financial success. However, the other legal forms are effective for those looking to make an impact on smaller level. The other legal forms, on average, experience positive returns. For those who do not have the funds or interest in starting an NBFC, Societies can be formed due to their simplicity and loose regulation. To see where all the legal forms stand side by side, the figure used earlier has been populated with the legal forms.

Chapter 5

Implications Can Be Drawn by the Global Microfinance Community

The results from the study of the Indian microfinance sector can be applied globally for improved success of microfinance all around the world. Legal form has an impact on client outreach and the financial sustainability of microfinance institutions, so promoting certain features of the best legal form will help increase effectiveness. It is important to note that time is a very important factor – the statistics may change over time, and what is best today may not be the best tomorrow. Nonetheless, other countries can formulate legislation and encourage certain types of legal forms in order to increase the client outreach and financial sustainability of their microfinance industries, thereby solving the problem of current microfinance industries not reaching everyone that they could.

In India, it was the NBFC that averaged the highest client outreach and the greatest returns on equity and assets. By taking the aspects of the law that allows the NBFC to succeed and surpass all other legal forms in these two areas, legislatures around the world can assist microfinance institutions with their mission of spreading financial inclusion and improving the lives of our poor.

Size was the most important factor that separated NBFCs from the other legal forms. Based on client outreach, 9 out of the 10 largest microfinance institutions were NBFCs. The ability of the NBFCs to grow so large comes from its ability to raise capital. NBFCs, by selling shares of their companies, had quick access to capital which allowed them to grow further and be more successful, attracting even more investors. The other legal forms do not have simple strategies for raising capital. They are often funded through donations and subsidies, but most of those who choose to allocate their personal funds in this area invest in NBFCs since they can actually get returns on their money. Other legal forms cannot pay dividends and usually have to reinvest all of their money into their business.

Size has a strong relationship with financial sustainability as well through the idea of economies of scale. The larger a microfinance institution grows, the more it saves through cost cutting and process. Thanks to their ability to raise capital, NBFCs also enjoy these benefits that save money in the long run. Other legal forms are not able to grow as quickly and therefore do not experience these benefits.

Therefore, it is important that countries wishing to build on India's model provide some way for microfinance institutions to easily raise capital. By doing so, microfinance institutions will be able to grow and reach more clients as well as cut costs through economies of scale. Social investors all around the world will be drawn to these microfinance institutions, thus helping them accomplish their mission.

Another factor that boosted NBFCs above the other legal forms was the professional management. Investors and even clients typically drifted towards NBFCs for their trustworthiness, which is exhibited through their openness in reporting and their business-savvy management. The management regulations are set by the Reserve Bank of India. By regulating the microfinance institutions to an extent, the government can assure the public that the microfinance institutions are indeed trustworthy. However, too much regulation can be burdensome on the institution can cause issues.

Lastly, the results from India show that the for-profit NBFCs outperformed the non-profit societies, trusts, Section 25s, and cooperatives. The for-profit status encouraged innovation and cost cutting and also attracted investors. It seems that competition and profits positively benefitted India's poor. Other countries should encourage competition and allow for-profit companies to operate in the industry for the good of the people.

By implementing the key takeaways from the legal forms of Indian microfinance institutions, countries all around the globe can improve the lives of their poorer citizens by improving the outreach capabilities and financial sustainability of their microfinance industries. Specifically, the characteristics of the NBFC that made it excel in helping microfinance reach more individuals were access to capital, professionalism, and competition. Therefore, other nations that encourage and implement these aspects into their microfinance industries will be able to start reaching more of the impoverished population.

Conclusion

The legal form of a microfinance institution is an important factor in determining the financial sustainability and outreach capabilities of the firm. The laws allow each microfinance institution different freedoms as well as restrictions which in turn influences their effectiveness in reducing poverty. NBFCs are the most successful legal form in terms of financial sustainability and client outreach, and are the second most popular legal form across the industry by number of institutions. Promoting NBFC creation and making it easier for them to operate can help with the fact that Indian microfinance is not reaching everyone it could. The pitfalls of the NBFC include the stringent regulations and steep start-up requirements, but are undoubtedly worth the investment as seen by their returns and numbers of clients served. Societies are the most common legal form due to the ease of formation and very little oversight, making them a good option for those that do not have the means necessary to establish an NBFC. As it turns out, a profit-oriented approach at benefitting society is actually more effective than the selfless, charitable approach overall. These findings can be applied to other microfinance industries to across the world in order to improve conditions for society's poorest by granting them financial inclusion.

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- Developed interpersonal and communication skills through hours of appointments in one-on-one and group settings with students of all backgrounds

Valuation Research Corporation – Financial Analyst Intern — May 2016 – August 2016

- Assisted with valuation analyses on companies and their securities across a wide range of industries using relevant qualitative information gathered and through the application of quantitative valuation models
- Conducted research on client, competitors, industry, and capital markets, including market multiples, comparable ratios, and credit spreads
- Modified and utilized financial models for discounted cash flow, guideline market multiple, market transaction, and fixed income valuation

ACHIEVEMENTS & ACTIVITIES

Penn State Marching Blue Band - Drumline Captain — August 2013 – May 2017

- Responsible for maintaining the traditional excellence of the Blue Band by leading 34 percussionists
- Gained leadership training and experience by attending weekly leadership training sessions
- Managed a full course load through 20 hours per week of practice and performance
- Learned to maximize efficiency in many situations by learning new halftime shows in 4 days

Penn State Provost's Award Recipient — 2013 & 2014
John Philip Sousa Band Award Recipient — 2013
Intramural Basketball — 2017

SKILLS

- Intermediate Fluency in French and Gujarati, Microsoft Office Suite, VBA Programming, and STATA