Enabling Inclusive Development

Public Finance Quarterly

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In this issue

2 Round the corner | 4 Feature Article | 9 Pick of the quarter | 12 Potpourri | 13 PwC updates

Editorial

Dear readers,

It has been more than two years now since we launched this newsletter. We initiated this to encourage active sharing of information and latest developments in the public finance domain. We have received much feedback and suggestions from you. I am extremely thankful to you for giving a very positive response to our initiative, thoughts and opinions that we have shared through this newsletter. Based on your feedback, we are continuously trying to improve the newsletter with more insightful articles and other information.

Continuing with our efforts to provide information on public finance subject, I bring to you the seventh issue of 'Public Finance Quarterly'. Our feature article in this issue discusses the recommendations of the parliamentary standing committee (finance) on the Pension Fund Regulatory and Development Authority Bill, 2011. The feasibility of the much-debated minimum government guaranteed returns on the New Pension System (NPS) has been examined. The likelihood of any additional financial burden on the government consequent to these guarantees has been assessed.

In *Pick of the Quarter,* we have highlighted the prevailing issues within the microfinance sector, thereby providing the ground for regulatory requirements. The article discusses the efficiency and equity concerns and impact of the draft Union Bill on consumers and service providers. It then presents a way forward to streamline transactions within this sector.

Our *Round the Corner* section provides updates on developments in government finances and policies across the globe. In *Know our Work* section, our experience in assessing options for developing the debt database for the central government debt of India with the Ministry of Finance has been presented.

In this issue, we have introduced a new section called *Potpourri* where we will present a mixed bag of facts and information about public finance. This time, we have presented an analysis of data provided in the recently published Indian Public Finance Statistics, 2010-11.

I thank you again for your overwhelming support and response. We would like to invite you to contribute and share your experiences in the public finance space with us. Please write to me at ranen.banerjee@in.pwc.com or to our editorial team.
Happy reading!

Sincerely,

Ranen Banerjee
Executive Director - Public Finance & Public Enterprise Reforms

Round the corner

Quarterly Stock of News Bytes and Releases

News bytes

PMEAC scales down GDP growth to 8.2%

Economic Outlook, India July 2011

The Prime Minister's Economic Advisory Council (PMEAC) scaled down its economic growth projection to 8.2% from 9.0% estimated in its February review. In its 'Economic Outlook – 2011-12' submitted in July 2011, PMEAC maintained that the inflationary situation and investment slowdown have necessitated a downward revision. The council expects the economy to grow at 8.2% in 2011-12 with agriculture growing at 3%, industry at 7.1% and services at 10%. The council states, "The projected growth rate of 8.2%, though lower than the previous year, must be treated as high and respectable, given the current world situation."

http://eac.gov.in/reports/eco_out1112.pdf

http://eac.gov.in/reports/revieweconomic_201011.pdf

The government of India and the World Bank sign US$ 200 million agreement to strengthen local government system in Kerala

Ministry of Finance, India; 5 July 2011

An IDA credit of US$ 200 million was signed between the Government of India and the World Bank in Thiruvananthapuram to strengthen the capacity of gram panchayats and municipalities in Kerala. The Kerala local government and service delivery project will fund improvements in local infrastructure to help Kerala towards greater decentralisation at the local level. The project seeks to strengthen gram panchayats and municipalities so that they can better deliver essential services such as drinking water supply, roads, sanitation, health and education. It will provide gram panchayats and municipalities with additional discretionary funds as performance grants for the creation and maintenance of its capital assets. It will also provide inputs to strengthen the capacity of these local bodies; strengthen the system that monitors their performance; and provide overall support to the project management unit within the local body.

http://finmin.nic.in/press_room/2011/GoI_WB_Kerala_agreement.pdf

India Signs an agreement and protocol for avoidance of double taxation and prevention of fiscal evasion (DTAA) With Lithuania

Ministry of Finance, India; 26 July 2011

The Government of India signed an agreement and protocol for avoidance of DTAA with respect to taxes on income and on capital with Government of Lithuania. The DTAA provides that business profits will be taxable in the source state if the activities of an enterprise constitute a permanent establishment (PE) in the source state. The agreement provides for fixed place PE, building site, construction and installation PE, service PE, off-shore exploration or exploitation PE and agency PE. The agreement will provide tax stability to the residents of India and Lithuania and will facilitate mutual economic co-operation between the two countries. It will also stimulate the flow of investment, technology and services between India and Lithuania.

http://finmin.nic.in/press_room/2011/india_sign_lithunia.pdf

New pension scheme launched for workers in Kerala

August 2011

The Kerala government has launched a new central government pension scheme 'Swavalamban Yojana' to protect workers in the unorganised sector in their old age. A person joining the scheme has to contribute 1,000 INR a year. The government will also contribute an equal amount annually till 2013-14. The accumulated amount will be invested by the government in funds having growth prospects. Beneficiaries will be able to avail pension when they turn 60, based on the amount contributed.

The scheme, introduced and promoted by the Pension Fund Regulatory and Development Authority (PFRDA), is implemented through selected agencies across the nation. ESAF Microfinance is the implementing partner for the scheme in seven states, including Kerala.

http://www.governancenow.com/gov-now/policy/new-pension-scheme-workers-launched

Release of the draft of the Micro Finance Institutions (Development and Regulation) Bill

Ministry of Finance, India; Released on 20 June 2011

This bill is to be introduced in the Parliament shortly. It will give access to financial services for the rural and urban poor and certain disadvantaged sections of the people. It will do this by promoting the growth and development of Micro Finance Institutions (MFIs) as extended arms of the banks and financial Institutions. It will regulate MFIs too. Some of its features are as follows:

- Designating the RBI as the sole regulator for all microfinance institutions
- Formation of a Micro Finance Development Council to advise on the subject matter to the central government
- Formation of state advisory councils to oversee microfinance at state level
- Creation of Micro Finance Development Fund for investment, training, capacity building or other expenditures as determined by the RBI

http://finmin.nic.in/the_ministry/dept_fin_services/micro_finance_bill.asp

Paper releases

'Fiscal Deficit and National Small Savings Fund' released by STCI Primary Dealer Ltd

By Amol Agrawal, 7 October, 2011

This paper explains central government's recent announcement to raise extra borrowings of government worth 52,800 crore INR during the second half of 2011-12. The author primarily attributes this to shortfall observed in National Small Savings Fund (NSSF) due to which the government had to raise money from market borrowings. The analysis shows that there might be an extra borrowing from states as well because of shortfall in NSSF and other factors highlighted in case of the central government. This is likely to crowd out the available savings for the private sector and put further upwards pressure on interest rates. Apart from market impact, the analysis also shows that both, the centre and state governments have not been following the prescribed ratio for sharing the NSSF funds. The central government is garnering a larger share of NSSF pool leading to more resources for the centre and lesser for the states. This is an additional cause of concern on nature of fiscal balances of the central government.

http://www.stcipd.com/UserFiles/File/Fiscal%20Deficit%20and%20National%20Small%20Savings%20Fund.pdf

World Economic Outlook (WEO), Slowing Growth, Rising Risks

IMF, September, 2011

The WEO presents the International Monetary Fund's (IMF) analysis and projections of the economic developments at a global level for several individual countries and country groups (classified by region, stage of development, etc.). It focuses on major economic policy issues and the analysis of economic developments and prospects. It is usually prepared twice a year, as documentation for meetings of the International Monetary and Financial Committee. It forms the main instrument of the IMF's global surveillance activities.

http://www.imf.org/external/pubs/ft/weo/2011/02/pdf/text.pdf

Global Financial Stability Report: Grappling with Crisis Legacies

IMF, September 2011

The *Global Financial Stability Report (GFSR)* assesses the key risks faced by the global financial system with a view to identifying those that represent systemic vulnerabilities. In normal times, the report seeks to play a role in preventing crises by highlighting policies that may mitigate systemic risks, thereby contributing to global financial stability and the sustained economic growth of IMF's member countries. Against the background of the weak economic recovery and slippage in global financial stability, the report highlights how risks have changed over the last six months. It traces the sources and channels of financial distress, with an emphasis on sovereign vulnerabilities and contagion risks. It notes the pressures arising from growing investor search for yield, discusses the implications of changes to global asset allocation patterns, and provides considerations on operationalising macroprudential policies.

http://www.imf.org/external/pubs/ft/gfsr/2011/02/pdf/text.pdf

Fiscal Monitor: Addressing Fiscal Challenges to Reduce Economic Risks

IMF, September 2011

Despite progress in addressing key fiscal weaknesses in many countries, significant policy challenges remain in advanced, emerging, and low-income economies. These must be faced in an environment where downside risks to growth have increased. Many advanced economies face very large adjustment needs to reduce risks related to high debt ratios. The appropriate pace of adjustment in the short run will depend, for each country, on the intensity of the market pressure it confronts, the magnitude of the risks to growth it faces, and the credibility of its medium-term program. The euro area needs to sustain fiscal consolidation, minimise its growth fallout and address concerns about the adequacy of crisis resolution mechanisms. In Japan and the US, sufficiently detailed and ambitious plans to reduce deficits and debts are required to prevent credibility from weakening. Meanwhile, many emerging economies need to make faster progress in strengthening fiscal fundamentals before cyclical factors or spillovers from advanced economies turn against them. Low-income countries also need to rebuild fiscal buffers, while addressing spending needs.

http://www.imf.org/external/pubs/ft/fm/2011/02/fmindex.htm

'Public Economics- Theory and Policy: Essays in Honor of Amaresh Bagchi', M Govinda Rao, Mihir Rakshit

Sage Publications, OECD, Economic Surveys: India 2011

The Organisation for Economic Co-operation and Development (OECD) provides periodic reviews of member and non-member economies. Member country reviews are generally done on an 18 month cycle, while non-member reviews are done as agreed with the subject country. A minimum of 18 surveys are done each year. Each issue provides a comprehensive analysis of developments in the subject country, along with individual chapters covering key economic challenges being faced and recommendations for dealing with the challenges.

http://www.oecdbookshop.org/oecd/display.asp?lang=en&sf1=DI&st1=5KM975G5VQ6L

Feature article

Gaining an Insight into Public Finance Arena

Guaranteed returns on New Pension System: Fiscal impact

Background

One of the significant reforms in the Indian public finance domain during the last decade include introduction of the New Pension System (NPS)'[1] in 2004. The demographic rationale for this was the lack of any country-wide social security system in India. It was estimated that only 12% of the working population[2] was covered by a formal pension system. Hence, there was an urgent need to establish a sustainable system ensuring reasonable income streams in old age.

This system's launch marked a shift from a defined benefit scheme to a defined contribution scheme to reduce the pension liability on government finances. Table 1 shows the comparison of defined benefit scheme with defined contribution scheme.

All new recruits to the central government services (except the armed forces) who joined from 1 January 2004 are included under the NPS. To extend its coverage, NPS was opened to all citizens in May 2009 including the unorganised sector on a voluntary basis.

The *NPS offer document,* among other things, prescribes the eligibility criteria for participation, application process, scheme's operational structure, scheme's benefits, investment choices and regulatory framework. It specifies *certain norms related to the minimum amount of investment per contribution during the year and number of contributions per year.* The associated charge structure (Table 2) makes small investments unviable. To make NPS affordable to *economically disadvantaged sections of society* with limited investment potential, a variant of the scheme, called NPS Lite, was launched in April 2011.

Table 2 compares the charge structure for economically backward classes and others.

Table 1: Comparison of Defined benefit scheme and Defined contribution scheme

Defined benefit scheme	Defined contribution scheme
Benefits at the time of retirement are defined.	Benefits are not defined but contributions by subscribers are defined.
Benefits at the time of retirement are based on a pre-defined formula which considers the age of the employee, years of employment, wage at the time of retirement, etc.	Benefits at the time of retirement are determined by the funds in the individual member's account.
The sponsor bears the risk.	The employee bears the entire risk.

Table 2: Charge structure for economically backward classes and others

Activity	Economically backward class	Others (in INR)
Account opening charges	35 INR	50
Annual maintenance charges	70 INR per annum, with 12 free subscriber contributions per financial year	280
Transaction charges	• Nil for the first 12 transactions • 5 INR per transactions beyond 12 free subscriber contributions every year • 5 INR per transaction switch/scheme preference, withdrawal	6 per transaction

Source: NPS-Lite offer document and NPS offer document

[1] Parliamentary Standing Committee recommended to change NPS from the existing New Pension Scheme to National Pension System

[2] Parliamentary Standing Committee on finance report on Pensions Fund Regulatory and Development Authority Bill, 2011

Low attractiveness

The uptake of this voluntary scheme has not been impressive, with only 51,000 subscribers as on 31 March 2011. Figure 1 shows the headcount of civil servants and subscribers on a voluntary basis for July 2010, November 2010 and January 2011. As on January 2011, only 0.016% of the working population had joined NPS voluntarily. The low uptake can be attributed to fluctuations in returns on pensioner's contributions.

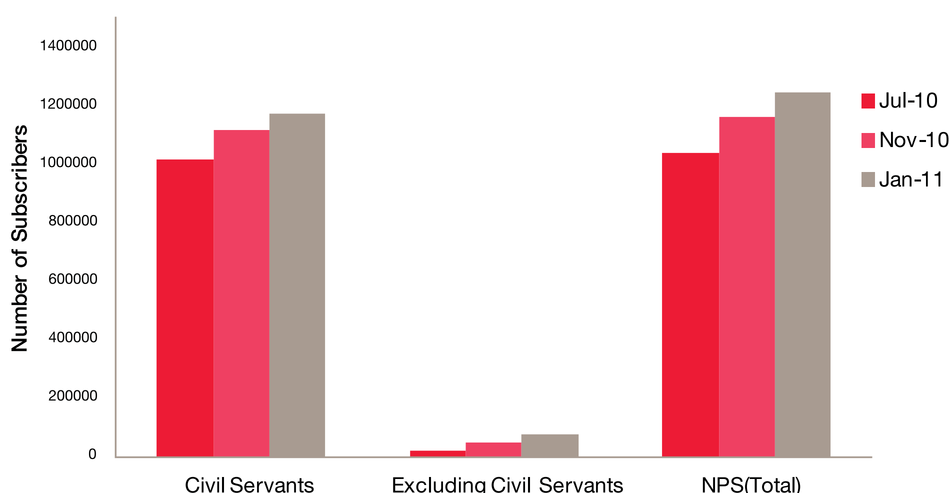
Although NPS was started in 2004, funds were invested in equity, corporate bonds and government securities from 2008 onwards only. Parliamentary Standing Committee on Finance, in its report, stated returns on NPS for government employees (Table 3) and for unorganised sector (Table 4).

High fluctuations observed on returns have been cited as major reason for low uptake. Hence, a need was felt to improve certain features of the scheme to provide assurance of returns on pensioner's contributions and for better coverage.

With respect to returns on NPS, the Pension Fund Regulatory and Development Authority (PFRDA) Bill, 2011 clause 20(g) states *"there shall not be any implicit or explicit assurance of the benefits except market-based guarantee mechanism to be purchased by the subscriber"*. A market-based guarantee mechanism can include the following:

- Absolute return guarantees,
- Relative rate of return guarantees (sector and benchmark based),
- Guarantees on benefit payouts; and
- Minimum pension guarantees.

Figure 1: Number of Subscribers (civil servants, others and total) under NPS (number of accounts)



Source: National Pension Scheme: For Whose Benefit? By Ayanendu Sanyal , K Gayithri , S Erappa

Table 3: Range of return for central government employees and state government employees, 2008-11(%)

Year	Central government employees		State government employees	
	Highest return	Lowest return	Highest return	Lowest return
2008-09	16.38	12.18	-	-
2009-10	12.27	8.88	6.34	5.94
2010-11	8.45	8.05	11.34	9.88

Table 4: Return on NPS for unorganised sector, 2009-11(%)[3]

Year	Return on government securities		Return on corporate bonds		Return on equity	
	Highest return	Lowest return	Highest return	Lowest return	Highest return	Lowest return
2009-10	10.02	1.82	10.04	4.02	25.94	7.95
2010-11	12.52	6.97	12.66	6.26	11.89	8.05

[3] Paragraph 22 of the report states that " ...low investment returns for state government employees and unorganised sector workers in government securities and corporate bonds reflect the fact that these investments were made for short periods and in short term instruments as the contributions of funds for these two sets of employees was irregular and in small lots which are less than the market lot for government securities and corporate bonds".

Against this backdrop, the Parliamentary Standing Committee on finance in its 41st report on the PFRDA Bill, 2011 August 2011 suggested that the existing provisions of the market guarantee mechanism are insufficient for stable and reasonable post retirement incomes. Consequently, it recommended some institutional restructuring measures to improve the subscriber base by providing assurance for a minimum rate of return benchmarked at Employees Provident Fund Scheme rate of interest.

The report states, *"The committee would recommend that the minimum rate of return on the contributions to the pension fund of the employee should not be less than the rate of interest on the Employees Provident Fund Scheme". It adds "If there is any shortfall, then the government in its Budget could bear the same and assume that additional responsibility."*

The fiscal implications of these recommendations have been discussed in detail. It has been debated that *committee recommendations, if accepted can create significant additional fiscal burden.*

In the following section, return on NPS fund is estimated based on the historical trends (1996-2009)[4] in return on equity, corporate bond and government of India securities; and the demographic profile of the working age population. Since NPS was introduced from 2004 only, an artificial construction of NPS for the remaining time period (1996-2003) has been done.

Analysing the returns on NPS and Employees Provident Fund Scheme, we have observed that there is a high probability that Net Asset Value (NAV) of the NPS fund will be higher than that of Employees Provident Fund Scheme. In this case, there are less chances of any additional fiscal burden on the government. This result is based on the assumption that NPS subscribers will remain contributing members for atleast 35 years.

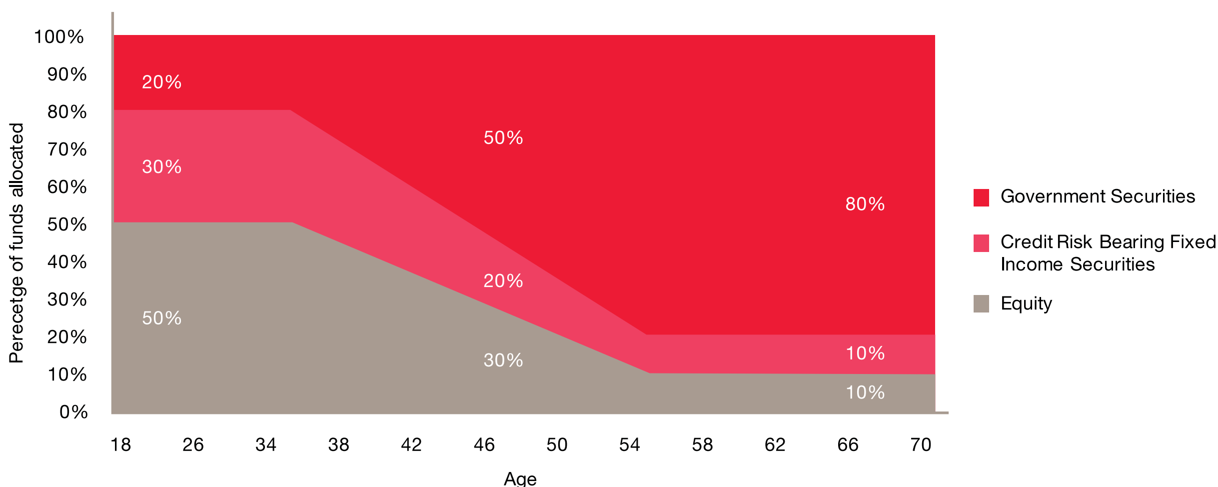
Returns on New Pension System

Under the NPS, funds can be invested in three options i.e., equity (asset class E), credit risk bearing fixed income instruments (asset class C) and government securities (asset class G). The distribution among these investment options requires some level of financial knowledge. However, the entire working population may not be expected to possess or have time to acquire this knowledge. If that is the case, auto-choice investment mode can be availed.

Under the auto-choice mode, the fund manager allocates funds among investment options based on the employee's age profile as depicted in Figure 2. The composition is structured to show the negative association between age and risk appetite of individuals. This means that as an individual ages, his/her investment portfolio comprises more of safer government securities and less of riskier equity.

From the experience of other countries, it is found that once an auto-choice mode is available, most subscribers opt for it. As on March 2010, only about 1.5%[5] of the India's population invested directly in the stock market. Thus, it can be assumed that most of subscribers will opt for an auto choice mode in NPS as well.

Figure 2: Proposed auto-choice structure (% of funds in Equity, Credit risk bearing fixed income securities and Government securities over different age groups)



Source: NPS offer document

[4] Data for the period prior to 1996 is insufficient for our analysis.

[5] Source: MCX –SX Indian Equity Investors Survey 2010

Table 5 shows that more than 50% of the working age population in India is between 20 and 34 years, as per population census 2001. This demographic dividend phenomenon implies that more than half of the subscribers (assuming auto-choice mode is selected) will have 50% equity share in their assets allocation under NPS.

Return on Equity

Given that such a large magnitude of funds will be invested in equity, return on equity in the future merits investigation. Figure 3 shows annual average stock indices for BSE 100 and BSE Sensex. From 1996 to 2009, the BSE Sensex grew at an average annual growth rate of 14.65 %, while BSE 100 grew at an average annual growth rate of 16.06%

Return on Government of India Securities

Apart from equity, funds can be invested in Government of India securities. To estimate return on government securities, average annual redemption yield on Government of India securities has been used as an indicator. Average yield on government of India securities with 15 years maturity for the time period 1996 to 2009 has been 9% p.a.

Return on Corporate Bonds

The other option in which funds can be invested is credit risk bearing fixed income instruments[6]. Figure 4 shows the AAA rating corporate bond curve for the period 1996 to 2009. The curve represents average yield on AAA rated corporate bonds during 1996 to 2009[7].

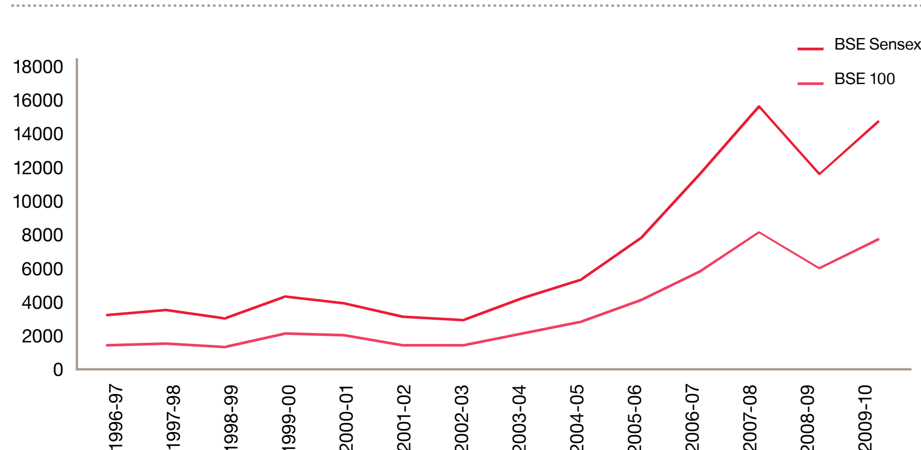
Average annual yield for 1996 to 2009 is estimated to be 10.95% (higher than government securities rate of return). In general, the rate of return is directly related to the risk associated with the bond. AAA rating bonds are considered to be the least risky corporate bonds and so bear low interest rates. Hence, the average yield estimated here represents *the most conservative measures of yield on corporate bonds*. Therefore, it is expected that government appointed fund managers with sufficiently good risk management strategies may earn higher returns than estimated.

Table 5: Working population and its distribution across age groups

Age	Population in millions	Share in the working age population (%)
20-34	247.4	51
35-49	173.8	36
50-59	64.2	13

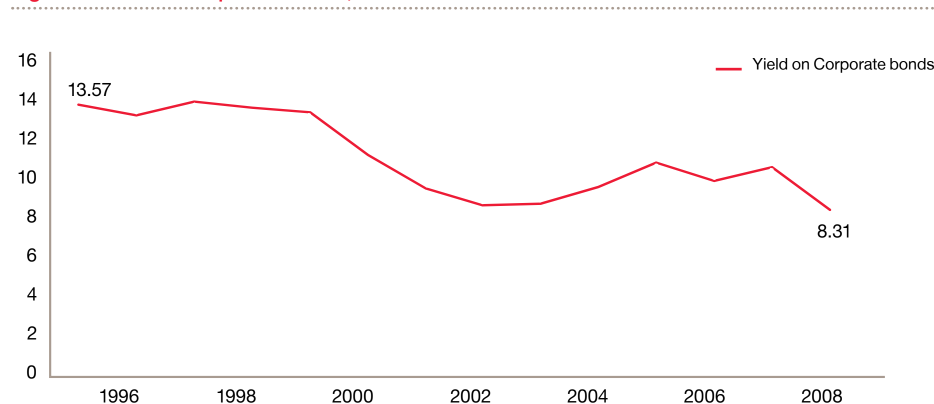
Source: Census 2001

Figure 3: BSE Sensex and BSE 100, 1996-2009



Source: Reserve Bank of India

Figure 4: Yield on Corporate bonds, 1996-2009



Source: Bloomberg (2007-09)

[6] As per the NPS offer document, credit risk bearing fixed income instruments include liquid fund of asset management companies regulated by the Security Exchange Board of India, fixed deposits of scheduled commercial banks, debt securities with maturity of not less than three years tenure issued by corporate bodies including scheduled commercial banks and Public Financial Institutions (PFI), credit rated PFI or PSU bonds, municipal or infrastructure bonds. In this paper, due to data constraints, return on corporate bonds is used as an indicator of return on assets class C, as used in the parliamentary standing committee report.

[7] Yield measures for 1996-2006 are estimated based on return on Government of India securities using average spread for the period 2007-09 from Bloomberg FIMMDA India Corporate Bond Curve AAA 5 Year.

Methodology for NPS rate of return calculation

Assuming that subscribers opt for auto choice mode, NPS rate of return is calculated through the following steps:

Step 1: Age-wise rate of return

$$[AR_{ij}]=[A_{ik} * R_{jk}] \quad \forall j, k, i$$

- i = Age , j = Year and k = Asset classes (E, C, and G)
- A_{ik} = Percentage of total fund allocated in k^{th} asset class for i^{th} age (Figure 2)
- R_{jk} = Rate of return for k^{th} asset class in j^{th} year.
- AR_{ij} = Rate of return on NPS fund for age i in j^{th} year.

Step 2: NPS rate of return[8]

$$NPS_j=[AR_{ij}]*[P_{ij}] \quad \forall j, k, i$$

- P_{ij} is percentage of population in age i for j^{th} year
- NPS_j is rate of return on NPS fund for year j.

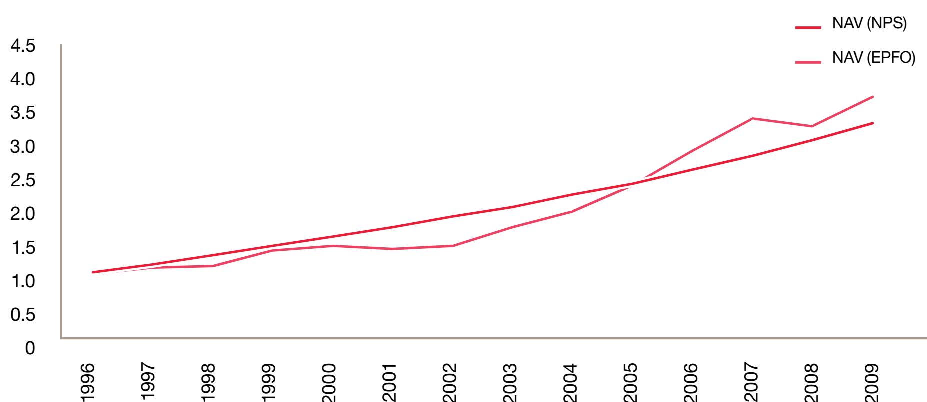
Results

Based on the estimated rate of return on NPS and Employees Provident Fund Scheme for 1996 to 2009, the NAV of NPS fund and Employees Provident Fund Scheme have been calculated. NAV have been calculated assuming INR 1 invested in 1996 (Figure 5)[9].

It can be seen in the Figure 5 that, from 2006 to 2009, NAV of the NPS fund was higher than on the Employees Provident Fund Scheme. However, from 1996 to 2004, NAV of the NPS fund was lower than the NAV of the Employees Provident Fund Scheme. Some of the causes for this trend were as follows:

- High Employees Provident Fund Scheme rate of return during 1996-2004(10%-12%) relative to the period 2005-09 (8.5%-9.5%)
- Negative returns on equity in 1998(13%) and 2001 (21%).

Figure 5: NAV on NPS and Employees Provident Fund Scheme, 1996-2009 (INR)



It is generally accepted that return on equity over a long term yields better returns since ups and downs are averaged out. Hence, return on the NPS fund must be examined with a longer term perspective.

From 1995 to 2009, the average return on two investment options under NPS i.e., equity and corporate bond were significantly higher than the rate of return on Employees Provident Fund Scheme. The average annual return on equity and corporate bonds were 12.95%, 11.18% respectively as against 9.69% average return on Employees Provident Fund Scheme[10]. Average annual return on government securities was 9% which was negligibly lower than the average return on Employees Provident Fund Scheme. This has resulted in the NPS average rate of return (most conservative estimates) to exceed the Employees Provident Fund Scheme average rate of return by 1.22 percentage points.

Based on the analysis and given the likelihood that the funds allocation under NPS will be more inclined towards high yielding options i.e. equity and corporate bonds in coming years, there is a high probability that NAV on the NPS fund will be higher than the NAV of Employees Provident Fund Scheme.

Can the period 1996-2009 be used as a representative of the next 35 years?

The period 1996 to 2009 can be taken as a reasonable representative of the next 35 years for our analysis. This is so since the return on equity, government securities and corporate bonds are found to be highly correlated with the overall performance of the economy. From 1996 to 2009, the average GDP growth rate was 6.95% which seems achievable in the next 35 years, given expectations regarding India's growth rate.

Conclusion

Our analysis has shown that the average return on NPS fund during 1996-2009 would have been higher than on Employees Provident Fund Scheme, assuming NPS had existed during that period. This is mainly due to the investment in equities under NPS unlike Employees Provident Fund Scheme. Further, it is established that 1996-2009 can be considered as a representative of next 35 years based on the performance of the economy and expected future growth rate. Hence, there is high probability that the NAV of NPS will remain higher than that of Employees Provident Fund Scheme in future also. Therefore, there may not be significant fiscal liability on the government with respect to assured return on NPS assuming NPS subscribers remain contributing member for at least 35 years.

[8]It is assumed that age distribution of population is the same as age distribution of NPS subscribers.

[9]Impact of policy changes over NPS return is beyond the scope of the paper, hence not considered.

[10]Since return on two options is compared in a relative sense, it can be expected that the number of people withdrawing from the NPS and Employees Provident Fund Scheme will be identical. The percentage of subscribers withdrawing before the age of retirement is kept at zero.

Pick of the quarter

Sharing a Viewpoint

Regulating Microlenders: "Preventing Failure or Protecting Interest?"

Lead up to regulatory reforms

In the '90s, mission microfinance began providing financial inclusion to the masses and gradually evolved as a social mission. Over the years, it translated into a successful, demand-driven business model with profitability being a prime concern for large number of entrants.

While extending their services to the masses below the poverty line, Micro Finance Institutions (MFIs) served well in bringing financial inclusion and eradicating poverty. However, the mission drifted over the years while moving up the market as the client centered norms were flouted frequently.

Issues around zero transparency in lending rates, coercive recovery tactics and overburdening client with unbearable liability led to the intervention by the state governments. Besides, the pertinent issue of last mile was not well served by most micro lenders that formed the core of its social agenda. Thus, a strong case started to emerge for regulation of this sector.

Regional fiasco

As the issue became a concern for state governments, Andhra Pradesh, that led the expansion of this sector with majority stakeholders, went to legislate reforms in 2010. These were perceived to have a detrimental effect on the business development and risked the existence of microfinance institutions.

Stocks of some of the big names in the business came tumbling down and uncertainty prevailed. States with competing MFI norms and an eagerness to regulate the functioning led to the appointment of a sub-committee of the central board of directors of the Reserve Bank of India, popularly known as the 'Malegam Committee'.

Recommendations of the Malegam Committee

To avoid multiple legislations within various competing states in the MFI sector, federal government instituted the Malegam Committee. This committee provided recommendations and a strong foundation for the Union Bill, highlights of which are as follows:

Issue	Recommendation
MFI classification	• Separate category of Non Banking Finance Company (NBFC) to be provisioned operating under microfinance sector as NBFC-MFI (other than a company licensed under Section 25 (not for profit) of the Companies Act, 1956
Regulation to be specified	• Uncollateralised loan should be given to a borrower who is a member of a household and whose annual income does not exceed 50,000 INR. • The amount of the loan does not exceed 25,000 INR and the total outstanding indebtedness of the borrower (including the loan) should not exceed 25,000 INR.
Interest pricing	• The suggested margin cap is 10% for MFIs having outstanding loan portfolio of 100 crore INR. • A standard form of loan agreement should be in place • Pricing of loan should have only the following three components: (i) A processing fee, not exceeding 1% of the gross loan amount (ii) Interest charge and (iii) Insurance premium
Multiple-lending and over-borrowing	• The borrower should not be a member of more than one self help group (SHG) or joint liability group (JLG). • Not more than two MFIs should lend to the same borrower
Set up of Credit Information Bureau	• To be responsible to provide information to potential borrowers regarding microloans
Moneylenders Acts	• NBFC-MFIs should be exempted from the provisions of the Money-Lending Act.

Source: Report of the sub-committee of the central board of directors of the Reserve Bank of India to study issues and concerns in the MFI sector, January 2011

Snapshot of provisions in the Bill

The Malegam Committee report and consultative process yielded results in the form of a Draft Microfinance Institutions (Development & Regulation) Bill, 2011 which awaits tabling in the parliament. Some excerpts from the draft bill are as follows:

- Mandatory registration of every MFI with the regulator (RBI was the suggested regulator) and subject to its guidelines
- Deliver periodic information to regulator and subject to penal action for violation of any rules
- MFI to register as a company upon attaining significant size
- MFI to be kept out of the money lending laws
- Bill provides flexibility to regulator to apply different measures and delegate the powers to National Bank for Agriculture & Rural Development (NABARD) for regulation
- Consumer protection initiatives such as mandatory enrollment with credit bureaus and code of conduct enforcement through industry associations has been suggested
- Margin cap on MFIs instead of interest rate cap
- Creation of Microfinance Council with ministry and RBI representation to ensure wider participation in policy making
- Microfinance Fund proposed to provide grants and bulk fund to MFI's for adopting innovation and use of technology in providing microfinance services
- Grievance redressal procedures to be put in place through appointment of an Ombudsman.

Source: The Microfinance Institutions (Development & Regulation) Bill, 2011 as on 20 June 2011

Upside and perceived gaps in the Bill

The upside	Perceived gaps
Requirement of all institutions regardless of size and form to register as MFI will provide effective regulation.	Ambiguity persists around exclusion of co-operative societies which constitute a large proportion[11] that register as MFI and do not auger well for customer protection.
Recommendation to compulsorily register profit making MFIs as a company *(NBFC)* will take away the leniency enjoyed as a section 25 company.	The Bill does not overtly talk about regulating usurious interest rates, a contentious issues prevailing in this sector. A wide segment of the poor will still be unable to afford the high cost of credit.
A variety of prudential regulatory guidelines and deterrence of penal action will result in reduction of unfair trade practices in this sector.	Creation of a council at the state and federal level may lead to gaps in policy making and render state councils defunct until a road map is chalked to ensure involvement of state councils.
Grievance redressal system will assist in speedy resolution of disputes.	The proposed bill lacks mention of moral and operational *'code of conduct'* which has been left for self regulation.
Exemption from money-lending law for MFIs will facilitate better availability of finance for the last mile (interiors).	Exemption from money-lending law for MFIs may fail to deter the ongoing coercive methods of recovery.
Granting permission to MFIs to initiate 'thrift services'[12] will enhance the savings culture among its customers.	It might be risky to grant collection of thrift considering the weak capitalised institutions of trust and societies that may be devoid of adequate safeguards without guarantee or insurance cover.

Sources:

- *Consumer Protection in Indian Microfinance; Lessons from Andhra Pradesh and Microfinance bill; Prabhu Ghate; 2006*
- *India's Microfinance bill answers most questions; N. Srinivasan, independent consultant and author of State of the Sector Microfinance India; 2008, 2009, and 2010*
- *Microfinance Bill: Missing the Forest for the Trees; H S Shylendra; Economic and Political weekly; 2007*

Experiences from other countries

Most of the countries where companies, NGOs, societies and trusts are involved in providing micro loans are governed and brought under the ambit of the respective central banks. In Asian countries such as China, Philippines, Vietnam and Thailand, the MFI regulation is an extended arm of the country's banking law regulations.

On the monitoring part *(Staschen; 1999),* the suggested MFI's regulation and monitoring can be either on-site or off-site by government, regulator or constitutional body or even a private supervisory institution.

The way forward

There have been concerns raised in different quarters on some elements of the Bill. These pertain to topics like the approval to collect thrift might place self-help groups at the receiving end due to negligent handling of savings that can be used up by MFIs for their own lending requirements. It can be suggested that regulator could have a relook in the medium term and recommend guidelines on investing thrift and provide adequate safeguard mechanisms to mitigate this risk.

Similarly, creation of national and state level council is a welcome step but will require efficient co-ordination and links between the councils or else the role of state counterparts will be reduced to namesake. A framework to have an inclusive approach requires some mentioning in the draft bill.

Another limitation concerns the exclusion of Section 25 companies (non profit) from the ambit of this Bill even though they have a broad representation. Hence, it might require a relook.

On a positive note, the draft Bill appears to be successful in resolving the crucial issues of consumer protection and concurrently provides reasonable space for the MFI's to carry on the business with an egalitarian approach, to control profit margins and minimise exploitation of poor.

As the bill is put forth for discussion, it will be imperative to address these key concerns to mitigate risks for all stakeholders. It is also necessary to ensure minimal collateral loss to the industry on account of capital outflow or unwillingness on the part of corporate to play a role in expansion of the sector.

Country	Regulatory authority	Interest rates (formally regulated institutions only)	Monitoring approach
China	China Banking Regulatory Commission *(CBRC)*	Interest rates between 8% to 18% depending upon the classification of MFI	Off-site visit of MFIs by China Banking Regulatory Commission (CBRC)
Indonesia	*Bank Indonesia* (Central bank of Indonesia)	• Interest rate for village credit institutions cooperatives: 18% • Rural banks interest rate between 36% to 48%	On-site and off-site inspections by provincial governments representative
Philippines	Bangko Sentral ng Pilipinas-BSP *(Central Bank of Philippines)*	Rural banks interest rate around 34%	Reviews undertaken on-site and off-site by MFI networked monitor and observance standards authority
Thailand	The Bank for Agriculture and Cooperatives Act (BAAC); Ministry of Finance	The Bank for Agriculture and Cooperatives Act (BAAC); Ministry of Finance	Inspection done by *Registrar Co-operatives*
Vietnam	State Bank of Vietnam	Central bank regulated 20% to 34% interest rates	Off-site and on-site inspection by regulator

Source: CGAP Microfinance Gateway

[11] Microfinance in India: A critique by Rajarshi Ghosh

[12] Thrift: Organisation authorised to hold deposits

Potpourri

A mixed platter

Interpreting the public finance numbers in the last decade

Analysis of data contained in the recently published Indian Public Finance(IPF) Statistics, 2010-11 clearly suggests improvement in the fiscal situation after the implementation of the Fiscal Responsibility and Budget Management (FRBM) Act with prescribed limits for deficit indicators since 2003–2004. These underwent revision when the Indian economy was hit by the global macroeconomic slowdown in early 2008–09.

- **Declining trend in fiscal deficit:** The fiscal deficit of the central government reduced to 2.55% in 2007-08 from its alarming level of 6.78% in 2001-02. It shot up again to 6.32% in 2009-10, but then has declined to 4.84% according to 2010-11 BE. A similar trend was observed in the revenue deficit, but in a slightly lower range during the same period.
- **Fluctuations in tax buoyancy:** A glance at revenue receipts at the centre exposes that tax buoyancy (calculated from the data reported by IPF statistics, 2010-11) has picked up from 1.18 points in 2004-05 to 1.56 points in 2007-08. However, it declined by 0.28 points in 2009-10 RE. This may have been due to the global economic slowdown since 2008-09.
- **Increasing non-tax revenue:** Substantial increase has been registered in non-tax revenues. Compounded annual growth rate over the last nine years of the decade is around 11.15%. This contributed to increase in the total central revenues.
- **Increasing development expenditure:** The share of developmental expenditure in total expenditure has consistently increased from 43% in 2001-02 to 50% in 2009-10 RE with no downward trend even during the global crisis. This encouraging trend provides scope for maintaining deficit target fixation while still meeting expenditure needs.
- **Declining central liabilities as % of GDP:** Internal liabilities with respect to GDP decreased to 51.5% according to 2009-10 RE from 59.6% in 2004-05. The external debt as a percent of GDP for the centre also experienced a decline to 2.1% in 2010-11 from its level of 2.6% in 2004-05. Market borrowings by the centre as a percent of GDP decreased to 3.77% in 2007-08 from 6.44% in 2001-02. Corresponding to the increase in fiscal deficit, this too moved up to 7.52% in 2009-10 RE.
- **Interest payment as a percentage of revenue expenditure decreased from 0.34% to 0.24% over the period 2003-04 to 2008-09.**

Like in the centre, the fiscal health of the states also improved after the implementation of FRBMA and the introduction of VAT.

- **Overall declining trend in fiscal deficit with inter-year fluctuations:** The fiscal deficit of the states taken together, which increased from 3.92% in 2001-02 to 4.27% in 2003-04, stood at 1.49% in 2007-08. Now, it is in the upper range of 3.17% in 2009-10 RE and 2.4% in 2010-11 BE, due to post adjustment of the global crisis. On the other hand, the revenue deficit for the states reckoned a declining trend after the implementation of FRBM and showed a surplus even during the period of the crisis.
- **Rising trend in tax revenues:** The tax revenue of the states followed an upward trend and grew at 14.12% in last 10 years.[13] This rise can be attributed to factors such as the widening tax base, improvement in tax administration at the state level and increase in indirect taxes through VAT implementation by several states during the last decade.
- **Recent deceleration in non-tax revenue:** Non-tax revenue collection for the states improved during 2003-04 to 2007-08. As a percent of GDP, it increased from 0.97% in 2001-02 to 1.24% in 2006-07. This has however declined thereafter to 0.89% in 2010-11 RE.
- **Declining liabilities:** The state liability as a percent of GDP declined to 21.1 % in 2010-11 RE from 26.3% in 2004-05. Loans to the states from the centre also decreased by more than 2 percentage points during the same period.

[13] Calculated as compounded annual average growth rate

PwC updates

PwC's Contribution towards the Sector

Know our work

Assessing options for developing the debt database for the central government debt of India, Ministry of Finance

In the budget speech of February 28, 2007, the finance minister announced that an autonomous Debt Management Office (DMO) should be established. The first phase should set up a Middle Office to facilitate the transition to a full-fledged DMO. A comprehensive debt database is significant for successful performance of the required functions of the DMO. In this regard, PwC has been asked to map the debt profile of the central government, identify sources of information for various debt components and assess options available for developing the debt database.

PwC's team analysed the internal and external debt profile of the central government including its public account, contingent and other liabilities. The team tracked the current status of debt management for central debt and met with various agencies responsible for managing and maintaining data on various components. The team visited their offices and gained an understanding about the databases of these agencies, the type of data maintained by them and the frequency of data updation to assess the status of debt information availability.

Thereafter, the team drafted the technical and functional features of the debt database based on the desirable functions of the DMO and their requirements. Further, the features and utility of two existing debt management softwares--The Commonwealth Secretariat Debt Recording and Management System (CSDRMS) and The Debt Management and Financial Analysis System (DMFAS) developed by UNCTAD--were assessed in the light of DMO requirements. Options of using existing systems of other debt management agencies and developing a new system were explored. Options were evaluated in the light of features, suitability, utility, cost implications, speed of implementation, ease of use and deployment. Suggestions were made accordingly.

Know our people

Dr Gautam Naresh

Dr Gautam Naresh is a Public Financial Management Advisor with the Public Finance & Public Enterprise reforms practice of the Government Reforms and Infrastructure Development (GRID), PwC. He holds a doctorate in Economics from the Banaras Hindu University and has varied experience in the area of public finance management. He has a work experience of over 33 years at the National Institute of Public Finance and Policy (NIPFP), New Delhi.

Dr Naresh has wide research and consulting experience in issues related to budgetary reforms, resource mobilisation, expenditure management, urban finance, fiscal federalism and tax and non-tax reforms, concerning the Government of India at all tiers. He has extensive experience in projects related to other fields of applied economics as well, viz., small-scale industries, rural economic problems, primary education, urbanisation and urban infrastructure reforms.

Dr Naresh was recently involved as the public expenditure expert in the ADB supported Advanced Project Preparedness for Poverty Reduction under the Meghalaya Public Resource Management Programme.
As part of the project, he reviewed recent policies and priorities, public expenditure structure and trends in sectors such as education and health. He also assessed the composition of recurrent expenditure in these two sectors and identified possible sources of budget savings for more effective use of spending while improving the standard of service delivery.

He was the team leader for the Study on Electricity Charges for Provision of Water Supply by Urban Local Bodies (ULBs) and Panchayati Raj Institutions (PRIs) in Madhya Pradesh under the DFID supported Strengthening Performance Management in Government (SPMG) Programme in Madhya Pradesh.

Dr Naresh has contributed towards developing the North East Region Vision 2020 with focus on the issues of local self governments based on findings from detailed field visits. He has been involved in reforming the property tax system in the Municipal Corporation of Delhi to the unit area method of tax assessment.

Dr Naresh has held the position of Honorary Principal Economic Advisor to the Second State Finance Commission (Union Territories), Ministry of Home Affairs, Government of India. He was a member of the Expert Committee on Property Tax Reforms in Municipal Corporation of Delhi, government of NCT of Delhi.

He has participated in policy-making deliberations in the First State Finance Commission for NCT of Delhi and UT of Chandigarh. He has served on secondment as Joint Director for Twelfth Union Finance Commission, Government of India.

He has participated and conducted various training courses for senior officers of Government of India, state officials and local government officials on the broad areas of taxation, expenditure management, public financial management, revenue administration, urban finance and property tax reform and fiscal policies and has, thus, developed good understanding and expertise these areas.

Hobbies of Dr. Naresh include watching sports and reading.

About us

The public finance practice of the Government Reforms and Infrastructure Development (GRID) SBU of PwC in India has been working closely with clients in the public sector and at all levels of the government as well as key donors such as DfID, JBIC, World Bank and ADB.

A large team of full-time dedicated professionals and associates provide services in public expenditure management, revenue administration, budgetary policy development, financial restructuring, performance improvement, institutional strengthening and capacity-building, accounting and financial management systems and human resource development.

PwC has been providing advisory services to governments, multilateral and private sector clients in the area of public finance. The work has broadly included budget reform, revenue augmentation strategies, automation or computerisation and debt management. Most of these projects has included training and capacity-building of government counterparts working with the public finance team on specific modules. In addition, the team has gained traction in the public expenditure and financial accountability (PEFA)/fiduciary risk assessment (FRA) areas with assignments across South Asia.

Workshop on the revision of the budget manual for the finance department, Government of Rajasthan

Contacts

Ranen Banerjee
Executive Director, PwC

PricewaterhouseCoopers Pvt. Ltd.,
Building No. 10, 17th Floor,
Tower C, DLF Cyber City,
Gurgaon, India 122002

Telephone: + 91 124 3306 009 (Direct)
Fax: +91 124 3306999
Mobile: + 91 9818886207
E-mail: ranen.banerjee@in.pwc.com

Editorial Team

Aashima Verma
Email: aashima.verma@in.pwc.com

Gunjan Bansal
Email: gunjan1.bansal@in.pwc.com

Contributors for this issue

Gunjan Bansal
Mehul Gupta
Pragya Sharma
Priyanka Agarwala
Sankalp Sah Jagati
Shrabani Mukherjee

pwc.com/india

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