ROLE OF CONTRACTS IN INTER-INSTITUTIONAL LINKAGE FOR FINANCIAL INCLUSION

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Abstract

Microfinance in India has been there since early 1970s. However, scale and scope of the sector recorded a phenomenal growth since min 1990s. The initial players of the sector have been the NGOs (Cooperatives, Trusts, Societies and not-for-profit companies) and the sector lacked a uniform regulatory mechanism. These institutions were run differently and followed different practices of accounting, book keeping and had varying levels of compliances. They faced scarcity of resources and hence depended on grants from multi-lateral agencies, government agencies and loans from Banks and FIs / Formal Financial Institutions (FFIs). They had to avail resources from these institutions and hence were required to enter into contractual arrangement, which was a risk minimisation tool for FFIs. However, there has been changes in the way contracts are written, which has shifted in approach from "sustainability" to "responsibility". However, client protection in the sector requires many more initiatives.

Introduction:

In the present papers, inter-institutional linkage is explored through contracts and its impact on financial inclusion in India. As we progress to the later paragraphs, the importance of contracts in shaping inter-institutional in financial transactions would be explored, study of which is critical for reasons such as, relatively recent origin of microfinance, which has largely been unregulated and thus was fragile and in constant flux. Prior to the Andhra Pradesh Micro Finance Ordinance 2010, which resulted in repayment crisis in the state, there has not been much regulation and institutions at the grassroots level were required to comply with various acts and provisions relating with their respective legal forms. Baring NBFCs, which were into microfinance, other institutions were not regulated. Due to varying legal formats, contracts between Formal Financial Institutions (FFIs, i.e. Banks and AIFIs) and Micro Finance Institutions (MFIs) were found to be important from the point of view ensuring the safety of formers money. However, contracts of pre-regulated era were only a risk controlling instruments. The regulatory framework introduced by Reserve Bank of India (RBI) provided for greater compliance to fair practice code and principles of corporate governance affecting the financial inclusion. The study is based on the review of available literature on contracts coupled with analysis of contracts between FFIs-MFIs and MFIs-JLGs. The paper attempts to understand these two contracts in the light of the theoretical works of economists and social scientists and to assess the impact it has on the inter-institutional linkage, which is considered critical for financial inclusion. The paper is organised into 7 Sections, which comprises of (i) Introduction, (ii) theories and forms of contracts, (iii) contracts in Indian law, (iv) contracts in financial markets, (v) contracts and regulation, (vi) discussion on financial contracts, and (vii) summary and conclusion.

Theories and forms of contracts:

A contract is a voluntary arrangement between two or more parties, enforceable by law and important for success of a financial transaction. A contract is often evidenced in writing or by deed, binding the parties by its covenants

regardless of whether they have read it or not. An unwritten, unspoken contract, also known as "a contract implied by the acts of the parties", can be either an implied-in-fact contract or implied-in-law contract, be legally binding. Implied-in-fact contracts are real contracts under which the parties receive the "benefit of bargain". An implied-in-fact contract may be created, when the circumstances imply that parties have reached an agreement even though they have not done so expressly. An implied contract is a quasi-contract, because it is not a contract but a means for the courts to remedy situations in which one party would be unjustly enriched were he or she not required to compensate the other.

There are various schools of contract, which comprises (i) Classical theory of contracts, (ii) Neo-classical theory of contract, (iii) relational theory of contract. Classical theory of contracts recognises the relationship among legal actors in terms of private and public, where the private indicates individual freedom or autonomy and is protected from state intervention or coercion. The individual voluntarily assumes liability by making a promise made through an agreement. As such, the state has no authority to impose any liability or obligation on individuals, if the same is not assumed, voluntarily. However, legal formalists believe that the law is based on neutral principles, which, if properly applied, would prevent judgements getting influenced by moral or political values of judges. Law is viewed as a self-contained system, in which decision flow from a limited number of discoverable and fundamental conceptual principles and doctrines, while contract liability did not arise solely from the individual's choice but came from the court's imposition of legal obligation as a matter of public policy. A contract is binding because, courts considered that imposition of liability served the social interest and not because the individual assumed liability, voluntarily.

The study of contracts is less than a century old and could be traced to the studies of Knight (1921) and Coase (1937). Knight emphasised that under perfect competition there would be no profit because the residue attained by the entrepreneur can occur only if there is a gap in demand and supply. The firm cannot be described by production functions alone and neither determine what to produce, which is a factor by the market forces. For him, entrepreneurship is the ability of manager to utilise the market information to his advantage. Coase developed his idea based on the work of Knight and discussed contract from the point of view of the firms and markets, stated that, market and firm exist side by side and perform transactions, which market can perform on its own and differentiates the boundaries within which market and firm transact and that the main reason for establishing a firm is to use the price mechanism to its advantage. Knight and Coase together lay the foundation of the contract theories developed in 1970s - Alchain and Demsetz (1972), Williamson (1975) and Hart and Moore (1990).

The neo-classical contract theory hinges upon trilateral governance - market and firm are the parties to a transaction, and courts are required for dispute resolution. However, as per the neo classical theory of price, there is no need for coordination as markets can perform these functions efficiently on their own and focuses on market (Kocsis – Szabo, 2000) and thus does not define firm or its existence. It only states that a firm is a conscious, rational, profit maximising and active organisation operating among well-defined market forces and disregards the entrepreneur.

Developed by Ian Rodrick Macneil and Stewart Macaulay, a relational contract is a contract based upon a relationship of trust between the parties to a contract. The explicit terms of the contract are outlined, and implicit terms determine the behaviour of parties to the contract, hence, a departure from both the classical and neo-classical theory of

contract. As it involves both agency and incentives, contract theory is often categorized both within the field of Law and Economics. From the point of view of law, the contract can be subdivided into complete and incomplete contracts. Complete is a contract that specifies the legal consequences of every possible occurrence in future. However, because it is prohibitively expensive to write a complete contract, in real world most contracts are usually incomplete. Pioneered by Oliver Hart and his co-authors, theory of incomplete contract states that it is impossibly complex and costly for the parties to make a contract complete and there are likely to be gaps, which may be a cause dispute and hence to deal with such situations the default rules provided in law fill in the gaps in the actual agreement of the parties. The idea of a complete contract is closely related to the notion of default rules, e.g. legal rules that will fill the gap in a contract in the absence of an agreed upon provision. The two most important classes of models in complete contracting theory are adverse selection and moral hazard models.

In adverse selection model, the principal is not aware of certain characteristic (“type”) of the agent at the time of writing a contract. There is typically too little trade, except when the agent is of the best possible type. The principal offers a menu of contracts to the agent, which is "incentive-compatible", if the agent picks the contract that was designed for his or her type. To make the agent reveal the true type, the principal must leave an information rent to the agent. In respect of Bank – MFI relationship, there is not much trade off as the relationship is not based on equality. While, the banks have abundance of resources, they are deficient in information, whereas, MFI are deficient in resources but have ample information about the grassroots. Hence, except for pricing, there is no negotiation, which is determined by credit risk perception and mitigation thereof, i.e. credit rating and collateral.

Moral hazard model of contract was pioneered by Steven Shavell, Sanford J. Grossman, Oliver D. Hart, and others in 1970s and 1980s and it states that, the information asymmetry is the principal's inability to observe and verify the agent's action. Performance-based contracts that depend on observable and verifiable output can often be employed to create incentives for the agent to act in the principal's interest. However, if agent is risk-averse, such contracts is only second-best because incentivization precludes full insurance. The moral hazard model with risk-neutral but wealth-constrained agents has also been extended to settings with repeated interaction and multiple tasks.

Contracts and Indian law:

The Indian Contracts Act, 1872 (ICA) provides legal basis to the contracts on Indian Territory. It defines a "contract", as an agreement enforceable by law, implying thereby that, those agreements that are not enforceable by law are not contracts. As per the ICA, all agreements are contracts if they are made by the free consent of parties competent to contract, for a lawful consideration and with a lawful objective, and are not declared to be void. In terms of ICA, every person is competent to contract who is of the age of majority according to the law to which he is a subject, and who is of sound mind and is not disqualified from contracting by any law to which he is a subject.

To form a contract, the parties must reach an agreement, which could be through offer and acceptance. An offer is a definite statement of the offeror's willingness to be bound by certain conditions. If a purported acceptance varies the terms of an offer, it is not an acceptance but a counteroffer, which is a rejection of the original offer. It is important to note that where an offer specifies a mode of acceptance, only an acceptance communicated via that method is valid. In

the context of the present study, the contracts broadly fall under this category, wherein FFI offers credit to MFI in response to the latter's request. However, as the credit is sanctioned conditionally, unless the MFI accepts the offer of the FFI, a valid contract is not established.

In the Indian context, largely studies on microfinance sector have focused on the contracts between MFIs and SHGs or JLGs. The contracts between FFIs and MFIs have not been explored. This study is an attempt is being made to analyze contracts between both the FFI with MFIs and the MFIs with JLGs. The contracts between FFIs with MFIs are generally standard, formal and "explicit", and are dependent on "external enforcement", i.e. an established third-party authority to enforce the contracts, which could be a court or a debt resolution authority. These are legally vetted and generally comply with the law of the land and requirements of regulator. Contrary to the above, MFI-JLG contracts are "implicit" and enforceable by "informal" means. These contract, further, entails no collateral requirement and no formal legal contract (Antara Haldar, Joseph Stieglitz, 2016). The enforcement mechanism in microfinance is neither external, nor can the external enforcement be replaced by one variant or another of joint liability, owing primarily to (i) the involved amount is very small and (ii) the cost of external enforcement is very high. MFIs-JLGs contracts are mainly ethical / moral in natures, which though require general adherence to the law of the land, does not intend to seek enforcement, legally.

An alternative set of explanations of the working of microfinance focuses on "social capital", which has two different meanings. (i) "implicit contracts" or "social contracts" enforced through a repeated game, where the members of the society have strategies that serve to enforce the desired behavior, (ii) broader interpretation of social capital, sees being connected, and maintaining the affection and respect of those with whom one is closely connected, as an essential aspect of advancing one's own sense of well-being. Social ties, relations and trust among individuals are often referred to as *social capital*, which has received increasing attention among researchers in the past few years. Cassar et al (2007) refer to the study of Ahlin and Townsend who found that strong social ties between group members were negatively correlated with the repayment ability of the group. They argued that there existed some forms of social capital promoting social sanctions. They also stated that social capital some-times obstruct the use of social sanctions and thus leads to negative effects on repayment rates. These studies offer contradictory findings on the role of social capital as a cause for high repayment. During our study on inter-institutional linkage, it was observed that resourcefulness and immediate liquidity position of the client determined the repayment behavior. If liquidity of the family did not allow, the client chose to default. In few stray cases though, they resorted to further borrowings from family, friends or landlord to clear the dues of MFI. Also, large number of respondents were of the view that timely payment is a good virtue as it paves the way for future assistance from the MFI. Hence, repayment behavior of clients offered a complex understanding of the issue.

In some studies, focusing mainly in African and South East Asian countries, it was observed that social capital, though important, did not determine the repayment behavior of the clients. As Zeller (1998) stresses a common thread among most NGO based credit organizations is to offer training or courses to their clients and hence they interact with their clients beyond just offering financial services. This is imperative to establish long term commitment and mutual trust, which is beneficial for both the lender and the borrower. The borrower may be less inclined to "take the money

and run" if she feels that the lender is willing to help her improve her situation over the long term. At the same time, the lender may be less harsh in difficult times, if they can see that the borrower is really committed to pay. The group training covers a broad spectrum of subjects ranging from business topics (e.g. entrepreneurial skills) to more family-oriented issues such as health, education etc.

As stated in earlier paragraphs, there are different views on the role of contract in repayment of loans. Formal contracts between FFIs and MFIs are generally adhered to and there are not many reported instances of contract violations. Even in worst times of Micro Finance Sector crisis in Andhra Pradesh, India, there were not many court cases involving FFIs and MFIs. This was due to nature of crisis, which was perceived to be political and hence needed a softer handling. This raises a serious question on the conviction of FFIs about contracts as an instrument of risk mitigation, while, FFIs did not blinked to invoke contracts in respect MSME, Personal and Consumer loan defaults. The FFIs resorted to restructuring the liabilities of MFIs on standalone basis or through Corporate Debt Restructuring, which in large number of cases failed, adopted persuasive methods to resolve the NPAs, written off huge amounts and settled account with MFIs. There appears to be certain reasoning besides being political, viz., even the MFIs could not recover much from the end beneficiaries mainly due to imposition of AP-MFI Ordinance. Hence, a legislative / administrative action can severely threaten the contracts and they could not be enforced.

Contracts in financial markets:

The present financial markets are characterised by contractual arrangements between various players and beneficiaries. Financial transactions necessitate contracts and enjoy legal protection hence, there is greater compliance. Further, the hierarchy in the financial system at the apex of which is RBI followed by AIFIs and Commercial Banks, i.e. FFIs. Below them are Regional Rural Bank (RRBs), Non-Banking Finance Companies (NBFCs) and MFIs. These institutions are separated by availability financial resources, i.e. while FFIs are free to raise resources within the regulatory framework provided by RBI, RRBs and NBFCs have limited instruments to raise resources and hence are dependent on FFIs. They are, therefore controlled by the contractual arrangement between them and other funding agencies. While, FFIs have huge pile of resources, their outreach is limited, whereas, NBFCs, MFIs, NGOs etc. have limited resources but deeper penetration in the market. Hence, these institutions require to play a complimentary role, which is critical for financial inclusion hence forge inter-institutional linkage.

As there are large number of players in the financial markets, the competition is also very high at all levels of the hierarchy. The competition among NBFCs, MFIs, NGOs has twin impact, i.e. (i) price control making the contractual arrangements relatively favourable to the needy, ensuring affordability and accessibility, and (ii) uncontrolled and unhealthy competition, wherein the same geographies get crowded with many players. NBFCs, MFIs, NGOs have captured the market, which was hitherto under the control of indigenous bankers, money lenders, charging exorbitant rates of interest. Owing to their numbers and zeal to spread out to large number of people, grassroots institutions tend to woo same target groups, leading to multiple lending to same client, which in times of crisis may prove to be counterproductive, as it happened AP. As MFIs and Informal Financial Institutions (IFIs) are pitched against each other and for multiple other reasons, relatively higher default takes place, which raises the cost as older institutions must make good for losses due to higher default, yet contract enforcements are far between and few.

The competition results in massive churning in the market and institutions, more organised - MFIs armed with good information about the local populace enter into the market, offering credit at relatively attractive terms with a focus on coverage of larger number of people, at times, hitherto excluded, resulting in establish players exiting the market. The MFIs are armed with cheaper resources, which traditional lenders (IFIs) do not have. However, the market churning may not be very smooth and generally there are confrontations, which lead to segmentation, dividing the customers in existing and potential, based on shared characteristics, namely social group, geographical contiguity etc.

Financial inclusion would ensure that the financial system shows signs of inclusiveness, which is accessible to all at reasonable cost if they are willing to bear such cost. Obviously, the FFIs alone cannot do much to cover entire population; hence, they look out for intermediate institutions, which could be cooperative banks, land development banks, cooperative societies and MFIs etc. Therefore, it is more than desirable that to meet the expectation of large mass of people, you need more lenders with knowledge about the local conditions, which will help them formulate easier terms and better contracts, both for safety of the credit and compliance of regulatory requirements. Contracts ensure that the cost and other condition regulating the transaction are known upfront.

In banking, a contract could be – a Letter of Sanction, Loan Agreement, Promissory Note, Bill of Exchange (negotiable instruments), alone or a combination of some, which becomes a contract when the offer is accepted by the parties to transaction. Hence, an agreement is an accepted proposal. In other words, an agreement consists of an 'offer' and its 'acceptance'. The parties to the contract derive their rights and obligations from the contract, where, offeree gets to understand the terms of the contract and the covenants, which could protect the consumer interest. The lender's objectives for the loan agreement are - (i) to set out conditions under which it will be obligated to lend, (ii) to enable it to monitor the borrower's financial situation, take remedial action if the borrower experiences financial difficulties, (iii) to provide the Bank a legally enforceable claim to its funds, or access to other remedies, if the borrower defaults. Offeree's (borrower's) expectation from a loan contract is, that - (i) funds will be made available when needed, (ii) at the most advantageous financial terms, (iii) payable over a period so that it does not place undue burden on borrower, and (iv) compliance with all other terms of the contract in its ordinary course of business.

All the banking contracts are essentially tools available to the banker for credit risk mitigation. Banking contracts are primarily in the nature of dos and don'ts for the borrower, violation whereof may result into penal provisions, including the recall of the loan.

Contracts and regulations:

After having discussed basic definitions and theories of contract, it is appropriate to discuss the contracts in banking and finance sector, especially the micro finance sector, which has undergone a sea change due to the recommendations of Malegam Committee recommendations. The committee was constituted in the year 2010 to investigate the aspects such as; the definition of 'Microfinance' and 'MFIs' for regulation of NBFCs undertaking microfinance, prevalent interest rates, lending and recovery practices, to delineate the objectives and scope of regulation of NBFCs undertaking microfinance, examine and recommend applicability of money lending legislation of the States and other relevant laws to NBFCs / MFIs, examine the role of MFI associations in enhancing transparency, disclosure and best practices, recommend a grievance redressal machinery and to examine aspects under which loans to MFIs can

be classified as priority sector lending and make appropriate recommendations etc. The committee made recommendations, which have far reaching impact on microfinance, main among them are - microfinance is perceived as a development tool whose objective is to assist the poor to work their way out of poverty. It covers a range of services which include, in addition to the provision of credit, savings, insurance, money transfers, counselling, etc. However, committee restricted its scope to credit to low income groups and vulnerable sections of the society.

In the process, it defined NBFC-MFI as ”a company (other than not-for-profit entities) which provides financial services pre-dominantly to low-income borrowers with loans of small amounts, for short-terms, on unsecured basis, mainly for income generating activities, with repayment schedules which are more frequent than those normally stipulated by commercial banks and which further conforms to the regulations specified in that behalf”. The committee further stated that there should be a “margin cap” on interest to ensure affordability. Institutions should adopt a standard form of loan agreement. All sanctioning and disbursement of loans should be done only at a central location and more than one individual should be involved in this function, with close supervision of the disbursement function. MFIs should lend to an individual borrower only as a member of a JLG and should have the responsibility of ensuring that the borrower is not a member of another JLG or SHG and that avail loan from upto two MFIs. The loan should carry a minimum period of moratorium between the grant of the loan and the commencement of its repayment and if violated, repayment should be deferred till all prior existing loans are fully repaid.

The committee further provided that all MFIs be required to become members of credit bureau. In the meantime, the responsibility to obtain information from potential borrowers regarding existing borrowings should be on the MFI. The MFI should ensure that coercive methods of recovery are not used and if violated their managements should be subject to severe penalties, adopt proper Code of Conduct and should have proper systems for recruitment, training and supervision of field staff to ensure that coercive methods of recovery are not used. They must have a Grievance Redressal Procedure and a Client Protection Code based on Fair Practices Guidelines prescribed by RBI. Similar provision should also be made applicable to banks and financial institutions which provide credit to the microfinance sector. The MFIs should review their back-office operations and make the necessary investments in Information Technology and systems to achieve better control, simplify procedures and reduce costs.

The committee also recommended that all NBFC-MFIs should have a certain minimum Net Worth, a system of Corporate Governance, Capital Adequacy Ratio. In addition to the above, committee felt that regulation of the sector was critical, however it suggested that the primary responsibility for ensuring compliance with the regulations should rest with the MFI itself and its management must be penalized in the event of non-compliance. Additionally, Industry associations must ensure compliance through the implementation of the Code of Conduct with penalties for non-compliance. Banks and FIs must play a part in compliance by surveillance of MFIs through their branches and RBI should have the responsibility for off-site and on-site supervision, especially the larger ones.

The contracts in India (except the areas / geographies excluded under relevant Acts / Laws of the Union / State) are governed by ICA 1872 and violation thereof could be referred to the court of law. While, large number of covenants are spelt out in the contract, there could be certain situations, which could not be foreseen to happen at the time of

contracts execution and are left to law enforcement agencies for resolution. In that sense, financial contracts are not "complete contracts". For instance, every banking contract has a clause on utilization of funds, which reads as under;

> *"The Borrower agrees to utilise the Loan / fund proceeds as described in Schedule I hereto. The utilisation of Loan / fund proceeds for any other purpose shall be made only with prior written permission of the lender."*

However, violation thereof is not spelt out in the contract documents explicitly and the lender resorts to RBI provisions on diversion or siphoning off or misappropriation related guidelines.

> *"In the event of default (principal , interest, cost and charges remain unpaid after the due date, covenants of agreement are violated, funds utilization is unsatisfactory or borrower has relied on wrong / fictitious information to avail the loan), the lender may, by notice in writing to the Borrower, declare the principal of and all the accrued service charge on the Loan to be due and payable forthwith, and the lender shall have a right to proceed against the Borrower under applicable provisions of law for recovery of the Loan."*

Clearly, the contract does not spell out the future course of action in the event of contract violation and leaves it to the law of the land for remedy. In the above sense, banking contract in India incomplete contracts. However, to strengthen the contracts, additional covenants such as the following are provided, which are essentially reiteration of the spirit of the contract and lender does this to establish its superior position and control over the borrower;

> *"The lender reserves the right to recall the Loan at any time if the performance of the Borrower is not found to the satisfaction of the lender or in the event of breach or violation of any of the terms and conditions. The Borrower shall be required to submit an audited statement for the end use of funds within 6 months of availing the disbursement. The lender also reserves the right to recall / expedite the repayment Loan at any time if the performance of the borrower is not found to the satisfaction of lender or in the event of breach or violation of any of the terms and conditions."*

Provisions as above had existed in the contract documents since time immemorial. However, post AP-MFI crisis, based on the recommendations of the Malegam committee, RBI came out with regulatory framework for MFIs, which have altered the contracts, substantially.

Discussion on contracts:

In the aftermath of AP-MFI ordinance and regulatory framework introduced by RBI, the contracts have undergone change. To assess the changes in the contracts, two types of contracts between (i) FFIs and MFIs (ii) MFIs and End beneficiaries have been perused and presented in tables 1 and 2, respectively.

Table 1 – Formal Contract between FFIs and MFIs

Formal Contract between FFIs and MFIs
(1) Introductory / Interpretation and Definitions 1. Details about the parties to the contract 2. Definition of terms
(2) Financial Covenants 1. Amount and the term of the loan 2. The project, where funds would be utilized 3. Interest that the loan would carry and penalty for delayed payment 4. Tenure of the loan 5. Conditions related to foreclosure of loan 6. Collateral / security
(3) Legal / statutory covenants 1. Clause for sharing information with credit information bureau 2. The date of commencement of agreement 3. Liability of borrower and lender
(4) Standard Covenants 1. Applicability of the contract 2. Definition of terms of standard covenants 3. Disbursement, Interest, other charges and repayments 4. Computation methodology for interest and dues 5. Acceleration of payments or prepayment 6. Due date of repayment 7. Reimbursement of expenses incurred by lender, by the borrower 8. Appropriation methodology for receipt of payments 9. Borrowers warranty 10. Creation of security / compliance with special conditions prior to disbursement 11. Constitution of project advisory committee 12. End use of fund related covenant 13. Accounting and internal control system of the borrower 14. Interest rates for on lending 15. Prohibition on certain kinds of lending / borrowing – generally within the group 16. Insurance 17. Notice for winding up of operations 18. Loss or damage by uncovered risks 19. Inspection and visits 20. Events of default defined and related penal provisions 21. Cancellation, Suspension or Termination of Loan 22. Waivers 23. Miscellaneous covenants
(5) Authorized Signatories of the borrower and lender

As may be observed from the above table, a banking contract may be divided into 5 broad sections, as under;

(1) Introductory / Interpretation and Definitions – this section comprises of the date, place and details of parties to contract, i.e. its name, address and normal place of business. The date is to indicate that the contract would come into force from a specific date. Place is stated in any contract to decide on the jurisdiction of the courts in the event of contract violations. The name of the borrower along with the Act under which such entity is formed (legal form) and address of the registered or corporate office of the first party and the name along with the Act under which such entity is formed and address of the registered or corporate office of the second party

(Companies Act 1956, modified 2013, Indian Societies Registration Act 1860, The Indian Trust Act 1882) etc. Thereafter, few key terms used in the contract are defined so that any future ambiguity may be avoided which may arise due to interpretation leading contracts infructuous.

(2) Financial Covenants – this section deals with the amount of the consideration, the brief of the project, where funds would be utilized, rate of interest that loan will carry and penalty provisions for default, tenure of the loan, covenants related to foreclosure of loan and securities – primary, collateral and guarantees, if any. Under these covenants, borrower and the lender reiterate as to where the loan amount would be utilized. For instance, the loans extended to MFIs by SIDBI, it would be utilized for on-lending by Micro Finance Institutions (MFIs) / Non-Government Organization (NGOs) to Self Help Groups (SHGs) / Federations of SHGs / individuals for setting up micro enterprises and / or undertaking income generating activities / non-farm activities etc. In respect of NABARD, MFIs / NGOs may utilize the funds to on lend to SHGs, individuals for setting up micro enterprises for undertaking income generating activities, including on-farm activities. Clearly SIDBI / NABARD / other Banks would like that the assistance extended by them are utilized in specified activities only. As SIDBI is mandated to extend assistance to non-farm and NABARD to farm activities, both insist that their assistance to MFIs are extended to non-farm and farm activities respectively. About assistance from SCBs, MFIs would require utilizing them, either and aimed primarily to enable them to meet their priority sector lending target requirements.

(3) Legal / statutory covenants – this section details about clause for sharing of information with credit information bureau (statutory and regulatory requirement under the Credit Information Companies (Regulation) Act 2005), the date of commencement of agreement and liability of borrower and lender (Indian Contracts Act 1872). Prima facie, this section exposes the borrower to public scrutiny since Banks are free to share the vital personal information about the borrower. However, the rights of the Banks and FIs are not absolute and come with certain limitations and caveats, i.e. the individual's rights of privacy and that the lenders would share the information for inter-bank financial due diligence or in the event statutory institutions seeking such information in larger public interest.

(4) Section 4 details the applicability of contract, definition of terms of contract, computation methodology of interest and charges, due dates of payment – amortization schedule, appropriation methodology, borrowers warranty to pay the bank dues, creation of security, terms of funds utilization, prohibition clauses, insurance, inspection, covenants related to closure or winding up of business etc. Under this section, the covenants are intended to ensure that there are no breaches to the intent for which credit is extended, which is a critical safety measure, as lender agrees to lend based on its assessment and prospects of success or failure of an activity. Any diversion of funds means that it is not being utilised for the purposes not informed to the bank. To that extent there is a breach of trust, which may attract RBI provisions on fraud and wilful default. The MFIs are expected to pay all the demanded money to statutory institutions, i.e. income tax, corporation taxes and other taxes to central, state or local government. This covenant is designed as a risk mitigation as in the event of disputes of the above kind, the first claim on the resources of the MFI is that of the Central / State / Local body, which if

substantial may render the MFI run into losses and affect its repaying capacity severely. MFI are also expected to comply with certain regulatory requirements of Reserve Bank of India or the Government of India or the Local Government, violation of which may render censuring the MFI, affecting its repaying capacity of the MFI. This section also provides that the MFI shall be subjected to regular audit and shall put in place a robust internal control system and that accounts shall be maintained as per the applicable / relevant statutes of the country. In the post AP MFI crisis, the Bankers / AIFIs have started stipulating a condition for reasonableness of interest rates and responsible financing covenants. The covenant reads "borrower MFI shall ensure that interest rate charged to its clients under the microfinance programme is reasonable and in line with the rates prevalent in the micro credit sector and the rate of interest is not in violation of any interest rate cap stipulated and applicable to the borrower, in any of the States."

(5) Section 5 of the contract is called attestation and provides for the signature of executants representing the borrower and lender, without which, any contract is not complete and thus not enforceable under law. In this section, an authorized person of MFI puts his signature (in case of a company, the signature is put under the common seal of the company, without which, the contract will not be valid), where after the contract becomes binding on both the borrower and the lender. In respect of partnership firm, all the partners or the managing partner, acting on behalf of all the partners, in respect of trusts, the chief trustee and in respect of society, its manager execute the document.

While, sections 1-3 form the core financial covenants, section 4 and 5 are enabling sections and provide a legal basis to the contract. From the point of view of completeness, it may be stated that section (i) and (v) may be considered as complete, whereas sections (ii), (iii) and (iv) have components, which may vary from case to case. Within this, section (iii) is dependent on changes in macro level policy modification, which may have impact on the financial sector, i.e. introduction of new regulation such as CICs Act 2005 or MSMED Act 2006 or changes in Companies Act 2013. However, provisions under section (ii) and (iv) are the ones, which may vary drastically and therefore all the contract violations are essentially violations of the provisions under section (ii) and (iv) of the contracts.

As regards, the responses from MFI officials on the influenced contract terms have on their operations, it is stated that the same does not have any formidable impact. However, looking at the fact that, with RBI providing the maximum spread on interest being charged by MFIs and the same getting incorporated in the FFI-MFI contracts, the RoI has seen a decline from over 26 percent to around 20 percent, pre-& post RBI guidelines. Further, the contracts also provide for geographical dispersal of the portfolio as a measure for avoidance of "concentration risk", MFIs have gone beyond the areas, where they have been traditionally operating. The contracts have instilled discipline, ensured corporate governance, provided for setting up of a dynamic organizational structure, which is to be properly audited and authenticated by third party agencies. As these requirements are linked with credit, MFIs have little option but to comply. To that extent, it can be said that FFI-MFI contracts of the present are a bit tight. Bankers find that contracts are legally vetted and thus sufficient to protect the interest of their respective institutions. Basis their constitution / legal form, MFIs are permitted to perform credit, savings and insurance activities. While credit services can be performed by all the institution forms – linked or otherwise, savings are allowed only if RBI has permitted the institution to accept deposits.

About, Insurance baring local area banks, none has been permitted to provide insurance (in-house), though, they are permitted to act as agents of IRDA approved insurance companies.

As stated in earlier paragraphs, the contracts between MFIs and JLG are primarily implicit and thus enforceable by informal means. Under this arrangement, the beneficiaries are members of JLG, and the loan assistance appears in the books of the MFI. Hence, risk is on the MFI, who is liable to pay entire of the borrowed amount for onward lending to the end beneficiary. The contracts between MFIs and its customers comprises of, letter of application (borrower), letter of sanction (lender) and mutual guarantee agreement (among the group members). In the letter of application for assistance, the JLG member declares her household income, indebtedness of the family and the undertaking that she has not availed loans from more than 2 MFIs and that she has not defaulted to any bank or micro finance institution. The borrower authorizes the MFI to collect information about the family of the borrower and an undertaking to enable it to share the same with credit information companies / bureaus. Further, the beneficiary undertakes that the she will abide by the terms and conditions stipulated by the MFI, and all the assets created would be hypothecated to the MFI as security for the credit availed, etc.

Table 2 – Contract under MFI-JLG Model

Declaration at the time of application: The borrower declares that; 1. My annual family income is Rs. _____ lakh. 2. The MFI will have right about the loan being given by it, (i) that it can sell the principal / interest there on to any Bank / Trust or Company at any point of time, (ii) This loan can be securitized or any individual / company or trust appointed by MFI would be authorized to do so and this entire process would be applicable to the borrower. 3. I also understand and declare that during the currency of the loan, in the event of death of borrower or the guarantor, the insurance company shall pay MFI the insurance proceeds. 4. We also agree to the following terms and conditions of MFI regarding "Members Confidentiality Policy"; i. The MFI shall not sell our personal / financial information to any other entity. ii. The MFI can share the above information to credit bureaus. iii. The MFI can part information about the borrower under the law establish by government or administrative order or by legal authority. iv. Photographs of the borrower would not be used other than on the application for loan or the passbook and MFI shall seek prior approval of the borrower for any other use. v. In addition to the loan, if any other product is offered to us, only such information would be shared, which would be relevant and has been told to us at the time of Centre Group Training.
Undertaking for Joint Liability: 1. We all women group members of village _____ are members of joint liability group and on this date, sign this undertaking. 2. We all members declare that we have chosen Smt. _____ as group leader of the JLG. 3. We all members declare that the above group leader will have authority to sign any document with the MFI on behalf of each member of the group, which shall be binding on every member of the group. 4. We also declare that we are agreeable to Rate of Interest ___% payable on weekly / fortnightly / monthly on reducing balance basis, and the installment shall include both, the principal and interest. 5. We also declare that any loan extended to any member of the group by the MFI in future and related all charges and interest would be our joint liability. 6. We also declare that the information given to MFI, could be after verification parted with credit bureaus.

The contracts between MFIs and JLG - a letter of declaration by client seeking assistance and mutual guarantee agreement among the group members, promising to pay the loans for other members in the event of default. In the letter of application for assistance, the JLG member declares number of members in the household, income of the household, indebtedness, financial and other assets of the household – both productive and otherwise etc. Such information forms the basis for assessment of the financial resourcefulness, which has assumed critical importance in view of large scale default in various parts of country under the sector.

Further, as part of contract, the beneficiary expresses her agreement for the right of the MFI, that it can sell the principal and interest thereon to any Bank or Trust or Company at any point of time and that loan can be securitized or any individual or company or trust appointed by MFI would be authorized to do so and this entire process would be applicable to the borrower. The client also undertakes and authorizes the MFI to collect the insurance proceeds to appropriate in the event of her death. However, the contract under this model offers the client a greater say as though the MFI can share the information about the borrower and her family with the credit information bureau but cannot sale the information for commercial use. The JLG members are also required to execute an undertaking for joint liability, called the Mutual Guarantee Agreement, signed by all the group members jointly and severally, unconditionally and irrevocably guaranteeing the repayment of the entire loan along with the interest granted to the group. As may be seen

from the above, the contract between the MFI with client is mutual and accommodative of each other's rights. The intent is the credit risk mitigation by the MFI and to ensure reasonable rights of the clients.

The contracts between the FFIs and MFIs are primarily in English, while the contracts between MFIs and JLGs are in vernacular language, which ensures that the covenants are understood by the client. However, looking at the level of financial literacy among the target population, the language of contract could only be a morally sound gesture as the target population has little understanding of the contract terminology. Also, due to general lack of understanding, the terms at which other players offer credit is not possible.

Summary and conclusion:

From the point of view of financial institutions, discipline and understanding the terms of credit is very important, therefore, study of contracts is critical. In the foregoing paragraphs, attempts were made to understand the contracts – its origin and various theories followed by legal support it enjoys. Based on the foregoing, it could be concluded that in respect of financial contracts, a contract is executed between two willing parties on mutually agreeable terms. It is also observed that the contracts between parties are generally incomplete, as it was not feasible to create a contract complete in all respects. There are certain contingency situations, which could not be foreseen at the time of contract execution and hence the parties to the contracts would depend on third party mediation in the event of violation, i.e. intermediation of a court of law or a debt resolution authority. Thereafter, an attempt was made to understand contracts between institutions – FFIs and MFIs (1) and between MFIs and JLGs. It is observed that the contracts are a tool of risk minimization / mitigation, which has assumed critical importance since the nature of businesses have transformed from "risk aversion" to "risk management", as in the finance risk and reward are proportionate, i.e. higher the risk – higher the reward and vise-versa. Therefore, Banks and FIs are keen to venture in those businesses, which are of recent origin and thus lack a trail of experience. Further, it was also observed that as the microfinance sector was largely unregulated, the contracts were found to be a tool to ensure the safety of the money being lend to new entities, which did not have much of past track record. It is observed that as microfinance business has moved from "sustainable microfinance" to "responsible microfinance", the natures of contracts have witnessed a change, influenced primarily by RBI guidelines to regulate the sector. The contracts of post AP-MFI crisis have an essential incorporation in the form of imposition of greater responsibility on MFIs, which includes adherence to corporate governance, non-employment of coercive methods of recovery, charging the reasonable interest rates, establishing audit and control functions and provision for grievance redressal mechanism etc.

The key changes that MFIs and JLGs contracts have witnessed is that while rate of interest have moderated, the MFIs are now keen to disseminate information about the code of commitment and fair practice code to their clients. Under the aegis of MFIN and Sa-dhan, these codes have been formulated and all the branches / collection centres of the MFIs are asked to prominently display these codes. The MFIs have also set up the grievances redressal mechanism to deal with violations by MFI officials while dealing with clients. Another, important change in the contract documents is that MFIs now insist on collection of general, non-financial and financial information about the households seeking credit. This has helped them better assess the repaying capacity of the clients, which has resulted in better compliance of contracts and reduction in instances of default. Further, with greater regulation under RBI guidelines, insistence on

Code of Conduct assessment carried out by a third party and MFIN and Sa-dhan the level of compliances have increased, substantially. Yet on client protection front further efforts are required to deal with age old practices relating to recovery in the sector.

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