REPORT OF
THE WORKING GROUP ON

COMPETITIVE MICRO-CREDIT MARKET IN INDIA

THE ELEVENTH FIVE YEAR PLAN
(2007-08 - 2011-12)

DEVELOPMENT POLICY DIVISION
PLANNING COMMISSION
NEW DELHI
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Development of Competitive Micro-credit Market
Minimization of Transaction Cost and Risk

1. Introduction

Both institutional and non-institutional channels exist for supply of credit in both rural and urban areas. While banks, microfinance institutions and credit cooperative societies comprise the institutional channels, landlords, local shopkeepers, traders/suppliers and professional money lenders constitute the non-institutional channels. The share of informal loans in rural credit went down from 91 per cent in 1951 to 45 per cent in 1991. Most of the benefits of this development have gone to the relatively better-off people. Around 66 per cent of large farmers are reported to have a deposit account and 44 per cent have access to credit. Against this, around 87 per cent of marginal farmers /landless labourers do not access credit from the formal banking sector (World-Bank NCAER, 2004).

The interest charged by the non-institutional channels, on informal loans, ranges from 24 per cent to 60 per cent. In some regions, it is reported to be as high as 120 per cent per annum. In comparison, the interest charged by the institutional channels varies between 15 to 28 per cent. There is, as such, hardly any competition between the two. Despite this, the non-institutional channels continue to have sway over micro-credit in India. In a way, this is primarily due to the limited outreach of the institutional sector in rural and remote areas.

1.1 Institutional Sector : Interest Rate, Outreach and Reliability

Amongst the various channels under the institutional sector (formal /semi formal banking sector), the interest rate charged by co-operative credit societies have been the cheapest. This is followed by interest rates charged by the commercial banks. The rate of interest charged by the microfinance institutions (MFIs), in general, is the highest of them all. These differences are, however, in terms of the quoted /nominal rate of interests. The better approach is to compare the differences vis-à-vis the effective rate of interest. Under the microfinance institutions model, for instance, the microfinance institutions go to the Self Help Groups/individual borrower both for lending credits as well as for collection of deposits. Some microfinance institutions are reported even to offer extension services/ providing know-how and marketing support to their clients. It is for this reason that despite the higher interest rate charged by them, the growth in credit outstanding of such MFIs has been in of the order of 30-40% per annum.

A comparison based simply on the rate of interest is, however, not good enough. The MFIs (Grameen Bank model/LABs/NBFCs) are concentrated in a few areas, driven primarily by dynamic individuals and dynamic markets. In comparison to MFIs, the PACS have a much wider reach. PACS out-perform both the banks and MFIs in outreach. The banks, nevertheless, out-perform both PACS and MFIs in terms of reliability and professionalism. The Bank-SHGs linkage programme as well as the Agency model of MFIs (both as business facilitators and bank correspondents) widens the range of delivery channels. The business facilitator – bank correspondent model has been announced by the RBI, but the banks are expected not to pass on any of the costs to the clients. Banks are not allowed to make loans less than Rs. 2 lakh at a rate in excess of Prime Lending Rate. This means that banks must pay facilitators out of the 11.5% or so that they are allowed to charge micro-clients. Not surprisingly they are offering just 1-1.5% to facilitators. This amount is un-remunerative for facilitators. This new agency/facilitator model has the potential to expand the outreach of the banks. However, in order to do this, the banks will have to find an appropriate model for meeting the full costs of facilitation within the existing overall cost structure (as specified by the Reserve Bank of India's circular dated January 25, 2006). Due to the greater involvement of Syndicate Bank and Canara Bank, it is observed that more has been achieved under the SHG-bank linkage programme in the areas of their jurisdiction i.e. in the southern states.

1.1.1. Interest Rate Calculation: Reducing Balance vs Flat Rate

The normal practice adopted by banks for charging interest on loans is that of 'reducing balance' or on the 'outstanding balance amount'. The MFIs, however, prefer charging interest on flat rate, as it is simple to calculate and easier for the borrower to understand. A 10 per cent flat interest on a sum of Rs.1000 works out to 19 per cent per annum on reducing balance (with weekly repayments) (Table 1). In other words, a high rate of interest on 'reducing balance' is equivalent to a much lower 'flat rate' of interest.

Table 1 Comparison of Interest Rates: 'Flat' v APR

(Loan size Rs.1000)

'Flat' Rate (%)	Total Interest Payment (Rs.)	Annual Percentage Rate (%)
10	100	19
15	150	29
18	180	35
20	200	38

Source: Wright, D.L. and A.H. Alamgir (2004).

1.1.2 Borrowing Costs (Cost of Funds)

According to a study on transaction cost in three microfinance institutions by Institute for Financial Management & Research, the largest contributor to direct transaction cost is collection charges (28-37%), followed by group formation cost (19-23%). Salary structure, conveyance costs and number of groups per field worker are some of the other key factors of operational costs.

One of the major components of rate of interest charged by the MFIs is the cost of funds. The MFIs depend mainly upon the funds borrowed from the commercial banks. Unlike other countries, the regulatory mechanism in India prevents MFIs from accepting savings from its borrowers. The number of savers in India, as per Ford Foundation report- 'Microfinance in India- A State of the Sector Report, 2006', is lowest in the world (4,056), whereas in Bangladesh it is 56,685 and in Sri Lanka it is 106,168. The MFIs in India are not able to take advantage of their outreach to mobilize savings because of the regulatory mechanism. The sector is dependant on the commercial borrowings which increases the cost of funds.

According to the Ford Foundation report, the financial cost ratio (cost of funds as a ratio of portfolio outstanding) is amongst the highest in the world at 8.5%, whereas in neighbouring Bangladesh it is 3.4% and in Sri Lanka it is 4.3%, because (as mentioned above) the MFIs do not benefit from the cost of funds collected as savings. In spite of this, the rate of interest in India is one of the lowest in the world, because of high repayment rates and high productivity of field staff. The borrowers per staff member in India are the highest at 439, whereas it is 131 in Bangladesh and 175 in Sri Lanka. Similarly, the cost per borrower in India is also one of the lowest at USD14, next to Bangladesh at USD10. The operating expense ratio of 12.3% is higher in India when compared to Bangladesh (11.9%) and Sri Lanka (10.4%).

As per the report the average profitability rate, as measured by return on assets, in India is negative at -1.5%, return on equity is -10.2% and operational sustainability is marginally below the break-even level of 100 percent because of lower (average) rate of interest of 20.7%. In contrast, the average profitability in Bangladesh is 3.6%, return on equity is 17.2% and the operational self sufficiency is more than100%.

2. Risk of Recovery: Wilful and Non-wilful Default

The formal banking sector has, in general, been wary of lending to the poor because of the fear of loan losses or inability to recover the loans, especially when the poor have hardly any asset to pledge as 'collateral'. This issue has been taken care of both in the case of bank – SHG linkage where the group guarantees the loan on behalf of the individual loanee. A majority of MFIs follow a similar strategy of first organising and then lending through SHGs. Those MFI's that follow the Grameen Bank model of direct lending to people, give loans to individuals through 'joint liability groups,' especially in urban areas where there could be chances of a loanee changing his her residence (90% of MFI loanees and SHG members are women) or migrate to some other place; but, the same cannot happen in the case of all persons constituting the 'joint liability group'. The repayments on the ground have been as high as 90-95 per cent and the chances of 'wilful default' have been greatly reduced.

2.1 Non-wilful Default

Group Guarantee, however, is not good enough in the case of non-wilful default arising from illness (or death) or similar conditions beyond the control of the borrowers. Risk of this kind needs to be addressed in a different manner. The various kinds of risks identified are : management risk, business risk (specific to a particular trade), market risk (arising from change in demand & supply/change in price), operational risk (for technological reasons) and financial risk (arising from interest rate changes or fluctuation in exchange rate) as well as legal and statutory risk (due to change in legislation) etc.

Management risk arising from the illness of the loanee, business risk due to crop_failure and market risk arising from lack of demand have been identified as the more important areas of concern vis-à-vis micro-finance. It is now a general practise amongst the banks and the MFIs lending to the poor to insist on the life and non-life insurance, which is available at a cost (at a premium). The banks and MFIs quite often set aside a certain per cent of the loan amount as insurance premium to protect their loan portfolio for situations arising from non-wilful default. IRDA, through its Regulation, has not only allowed MFIs/NGOs/Co-operatives/SHGs to act as micro-insurance agents it has also required insurance companies to originate a proportion of their business (from 11-18% depending on the length of an insurance company's engagement in the Indian market) in rural areas. This measure has given an impetus to micro-insurance where there was none before.

3. Costs of Funds and Determination of Interest Rates

There are three kinds of costs incurred by the formal financial sector, namely (a) cost of funds, (b) operating cost and (c) cost of loan losses. These costs are, however, not the same for all the channels of the institutional banking sector**.** The commercial banks perform the function of intermediation between those who save and those who borrow. They are, therefore, able to raise funds through deposits from those who save at very low costs, which may range between zero (on demand deposits, better known as current accounts) to eight per cent (on term deposits). Amongst the commercial banks also the public sector banks have lower cost of funds compared to private sector banks as the former have a larger portfolio of demand deposits.

3.1 Financial Costs to banks and SHGs

Under the Bank-SHG linkage the banks make funds available to SHGs at around their prime lending rate (PLR) that may range between 11-12 per cent. The SHGs on-lend the funds to their members at rates ranging from 12% to 60%. However, generally, the rate charged by SHGs to members is around 24%. A recent study of 214 SHGs in 108 villages of 4 states – Andhra Pradesh, Karnataka, Orissa and Rajasthan – has shown that 80-90% of SHGs charge their members =/>24%. The exact numbers were Andhra Pradesh (83%), Karnataka (92%), Orissa (86%), Rajasthan (78%) of SHGs that charge =/>24%. Only 10% of the entire sample charged their members less than 18%.

As per this study, "24% is the norm since it allows a margin above the rate of interest payable on most external borrowings. Group members usually agree to this as a reasonable amount which is less than the informal (moneylender) rate, and represents a margin that goes back into their own group fund."

In the context of the SHG-bank linkage programme, the following observation is of interest:

'Though, the profitability of SHG lending is not yet fully established, indications are that banks are able to do this business without losses even when interest rates are capped at 12.5 per cent. Indeed recently, the State Bank of India has announced its intention to lend at lower rates. This is spurred by the fact that due to cut in deposit rates, the cost of funds for banks is going down and at least so far the level defaults in SHG portfolio is small. About transaction costs, banks have the view that they any way have a rural branch network with all the fixed costs and there are little incremental costs for SHG lending.

A few studies have examined lending to self-help groups by some commercial banks and regional rural banks and found it to be profitable. For instance, Bank of Baroda, one of the largest public banks most involved in lending to self-help groups, had a regular repayment rate of nearly 100 per cent and reasonable transaction costs, so the total cost of this lending was not higher than for large loans. Oriental Bank of Commerce, a small public bank, has also developed profitable lending to self-help groups

Bank of Madura, an old private commercial bank, has found the self-help program so satisfactory that it has made it part of its strategy for achieving viability in its 104 rural branches. Bank of Madura, now part of the large private ICICI Bank, highlights the importance of finding innovative solutions to cut the costs associated with the program and confirms the privileged role played by the private sector in innovating. Bank of Madura expects its self-help group lending to become profitable even without using NABARD refinancing.

These success stories could be circulated to encourage commercial banks to include self-help group lending in their business strategies, and innovative strategies to cut the cost of the program could be shared with other practitioners' (Mahajan, 2006).

3.2 Operating Costs of Micro-Credit

The operating cost of servicing micro-finance/micro-credit is higher than normal (bank) finance, however. This holds good for commercial banks (including RRBs), MFIs and credit co-operatives. Salaries to staff, travelling expenses, commissions not classified under financial costs, expenses on promotion of groups, staff welfare expenses, amortization and depreciation, rent on hired buildings and other overheads-all constitute the operating cost. These costs are critical to the operations of the formal banking sector. Taking cognizance of these costs, results in a far higher calculation than taking the (above) view that the overhead costs need not be allocated to the SHG-bank linkage programme since it is being incurred by the bank anyway.

'The data shows that all the bank branches, irrespective of SHG promotion mechanisms, are making substantial losses in lending to SHGs due to pricing of SHG loans below cost. These loans carry the lowest interest rates of all products in all the sample banks (12.5-13 per cent per annum), and this does not allow the banks to earn a spread even with the most efficient operating system. The five RRBs studied in the sample showed that the cost of SHG lending varied from 22-30 per cent (even if one excluded an RRB where it cost over 48 per cent, as an outlier). Thus, unless banks increase their interest rates on SHG lending to the range of 24 per cent, it is unlikely that they will make any profits. However, efficiency improvement in operations of RRBs as also economies of scale with more SHG lending may also reduce the breakeven pricing to perhaps 21 per cent' (Sinha, 2005).

The net effect of ignoring overhead costs is to lower the apparent cost of banks lending to SHGs but it means that such lending can then take place at each branch individually only to the point where the existing "slack" in the overhead is fully taken up. Lending to SHGs beyond this point will require the bank to incur further overhead costs and, at this point, the full cost of lending to SHGs would have to be taken into account. In this context, it is worth noting that the above study found that even in the case of individual RRBs in south India (where the SHG-bank linkage is very much in vogue) the SHG portfolio did not exceed 11% of advances in the best of branches. Overall, the outstandings of the entire banking sector to SHGs does not exceed 0.5% of their total advances.

3.3 Costs to MFIs

The costs incurred by any financial institution in making loans is made up of three main components (i) Financial Costs (or costs of raising money for making loans), (ii) Operating Expenses (or staff, travel and other administrative costs of servicing the loans) and Risk Costs (or costs of covering for the risk of losing capital on account of the inability of the institution to recover loans whether or not default is wilful).

3.3.1 Financial Cost

The other credit lending institutions like the credit co-operatives and the MFIs may not have sufficient deposits, as the commercial banks (& LABs) to undertake credit activity on their own. They are, therefore, dependent either on refinancing facility from agencies, such as, the NABARD, the SIDBI, the Rashtriya Mahila Kosh or borrowings from the commercial banks (including the RRBs). The respective financial cost involved under each category may be seen from Table 2 below:

Table 2: Financial Cost to MFI
(on a one year loan)

	Institution	Rate of Interest (on declining balance)
I	NABARD	8-9
	SIDBI	8-9
	RMK	8
II	Commercial Banks	
	a. Public Sector	12
	b. Private Sector	14

Funding may be made available to MFIs by the development agencies (SIDBI/NABARD) also by way of subordinated debts, as promoter's/member's capital (or equity/quasi equity) as well as grants from donors. In view of the high set up cost, the development institutions may charge a lower rate of interest to the MFIs in the initial years, which may be raised subsequently once the MFI has matured. Equity other than 'grants' is, obviously, the cheapest of all funds as there is no interest liability and payment of dividend is to be made only when profits have been earned. The financial cost to the MFI will, thus, be the weighted average of all the different kinds of funds.

3.3.2 Operating Cost

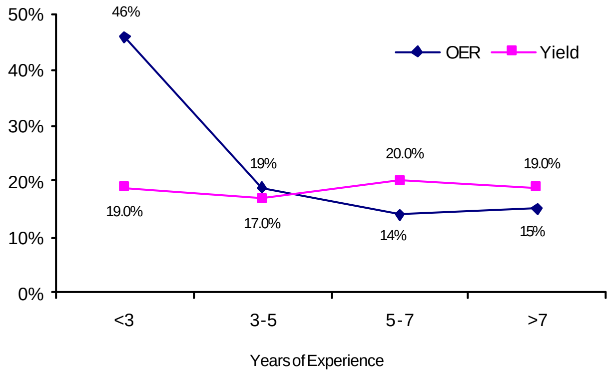
Salaries, moreover, account for the major cost of these institutions. The sustainability of micro-finance at low interest charges thus depends greatly on staff efficiency. In simple terms, efficiency depends on how many clients a staff member is able to deal with. By and large, MFIs in India are able to service some 150-250 clients per staff member. The larger institutions are able to service more borrowers per staff member as some economies of scale take effect. The leading ten MFIs in India service some 239 clients per staff member. This amounts to the operating expense ratio (OER) of these institutions declining as the size of portfolio increases.

The table/figure below gives some idea of start up costs – the first three years and a portfolio size of Rs1 crore are crucial. Beyond this level operating expenses decline to 20% and after about Rs.2.5 crore to 14-15% of outstanding portfolio. The really large MFIs are able to achieve 10-12% OERs.

Exhibit 1

Operating expenses and portfolio yield by age of MFI

Age (years)	OER	Yield
<3	46.0%	19.0%
3-5	19.0%	17.0%
5-7	14.0%	20%
>7	15.0%	19.0%
M-CRIL India	**18.5%**	**19.1%**
Top 10	12.3%	24.8%
MBB	**20.2%**	**38.1%**



3.3.3. Provision for Loan Losses (risk costs)

Generally, 2 per cent of the loan outstanding is set aside as the normal loan losses in micro-credit and the banking institutions have no option but to load this cost into the lending rate of interest.

3.3.4 Need for 'capitalization'

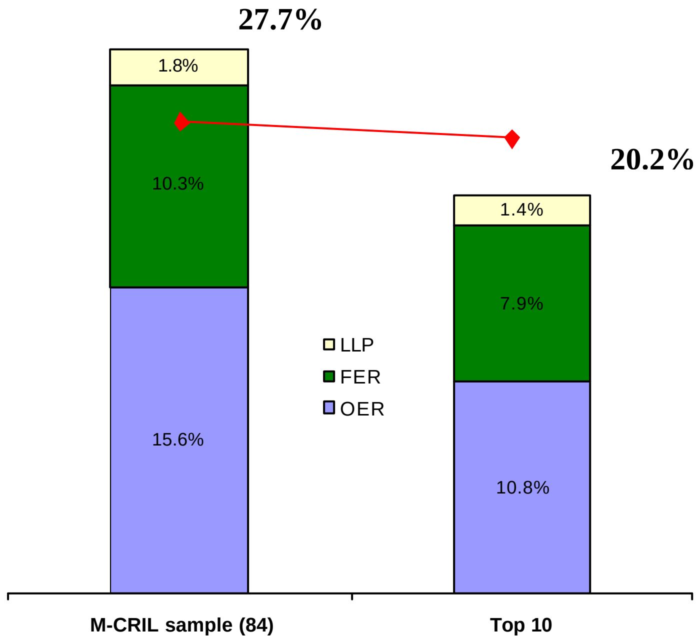
The interest rate charged on bank credit is also the most important instrument of building 'reserves' through higher profits. A minimum capitalization is considered necessary for building the equity base through retained earnings. This strengthens the capacity of these institutions for both leveraging higher borrowings from lenders / banks as well as to attract more equity due to the ability to pay higher dividends to the shareholders. The interest rates charged by banks or MFIs are linked to the costs incurred in servicing such debts. The final interest rate fixed thus becomes a contribution of all these four components (Table 3). The Table below provides a general idea of the costs involved in servicing micro-credit, which eventually determines the lending rate of interest. A rate of interest between 22 to 26 per cent may perhaps be most reasonable to be accepted.

Table 3: Determinants of Interest Rate on Micro-Credit in India (on declining balance)

Description	Annual Percentage Rate (%)
(a) Average Financial Cost of Funds – assuming borrowing at 10-12% but around 70% of on-lending funds comes from borrowings while the rest is from grants or internal generation of surplus or a small amount from "compulsory savings" (or cash collateral)	6-9
(b) Operating Expenses	10-14
(c) Loan Losses	1-2
(d) Desired Capitalization Rate – assuming a 30% growth rate and a capital adequacy ratio of 15%, banks will lend to MFIs if they raise around 4.5% in the form of "own funds" – part internal resource generation (which is this amount) and part equity finance from SIDBI, NABARD and MF equity funds currently in existence and being established	3-4
Annual Effective Interest Rate	22-26

In comparison with the 3-4% administrative/operating expenses incurred by banks servicing their average borrowers, efficient MFIs incur 10-14%. Compared to the average MFI client who takes loans of around Rs5-6,000 with average outstandings of just over Rs 3,300, even a relatively small client of a bank has loans of Rs35,000-50,000. The cost differences – as a proportion of the size of the loan – are not surprising

The internationally recognised rating agency for MFIs, M-CRIL has recently concluded a review of 84 ratings of Indian MFIs undertaken over the past 3 years. A breakup of the costs incurred by all 84 MFIs taken together and also the leading 10 MFIs (Top10) separately is presented in the figure below. The yield for the large sample is 25% whereas the Top10 earn 23.9%. The red line shows the yield. What this means is that the average MFI makes a loss whereas the Top10 (that serve 67% of MFI clients) earn a 3.7% margin which is sufficient to enable roughly 30% growth since this capitalisation enables them to generate around 8 times the amount in debt from banks. On this basis, 24% is a reasonable rate for MFIs to charge from clients since this is what it costs to service the loans and maintain some growth to serve larger proportions of the population. The problem is that the smaller MFIs cannot survive at that rate and would need much cheaper funds – say at 4% to keep their financial expenses (Financial Expense Ratio - FER) down.



The Red line above is for weighted average yield (25.2% for full sample and 23.9% for Top10). [See M-CRIL Microfinance Review]

The 24% cost of micro-lending that efficient MFIs can reasonably charge is well below the costs of informal sector borrowing in all but a very small part of the country and is very much in line with the cost of consumer lending even by the scheduled commercial banks.

3.3.5 Need to charge cost-recovering interest rates

The sustenance and economic viability of MFIs depends on charging of interest at the rate of 21-24%. Sa-Dhan, (an association of MFIs) has laid down Model Mutual Code of Conduct for Micro Finance Institutions. It advocated interest rate of 21-24. Sa-Dhan's model code of interest is based on the following cost-

Interest rate schedule for MFIs

Item of cost	Basis of cost	Percentage of
Cost of Funds	SBI Prime Lending Rate	9%
Cost of delivery of credit	Money order charges by government post office	5%
Cost of Collection of payment	Money order charges by government post office	5%
Cost of provisioning for bad debts	As per RBI norms, based on extent of bad debts	1-3%
Profit margins	Minimum required to maintain capital adequacy as per RBI norms	1-2%
Total		21- 24%

The performance of the MFIs cannot be judged purely on the basis of rate of interest. MFIs have numerous other advantages like outreach, delivery and collection of loans, etc, which makes it more attractive than the formal sector. The MFIs deliver and collect consumer loans virtually at their door step and at intervals convenient to the borrower.

To counter the criticism that the MFIs are charging higher rate of interest there is an urgent need for creating awareness about the need for charging cost-recovering interest rates. The microfinance institutes reach roughly one fifth of the poor households and small percentage of non-poor households. Sustenance of these institutions and their continued support to the poor households depends on charging cost recovering rate of interest

4. Conclusion

In view of the high economic growth and an expanding domestic economy, micro-credit has a good future in India. Moreover, as the institutional sector dealing in micro-credit expands, it reduces the need of the poor to approach the informal sector for credit. A combination of micro-lending by larger and more efficient MFIs and direct lending to the poor by banks could help to cover the vast majority of the financial needs of low income groups in India. This will, however, require a determination of the formal banking sector to promote the inclusion of the majority of the population in the financial system of the country. Micro-credit constitutes a very small percentage of the total lending of the commercial banks (less than one per cent). There is good scope of cross subsidisation by banks both through low cost wholesale lending to MFIs and through direct lending to low income clients. Banks could be encouraged to undertake such lending and could be incentivised to do this through being allowed to charge commercial rates of the order of 18-20% on such loans.

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Annexure I

No.20(5)/DP/PC/2005
Government of India
Planning Commission
(Development Policy Division)
...

Yojna Bhavan,
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New Delhi- 110 001
7th July, 2006.

O r d e r

Subject:- Working Group on Development of Competitive Micro-Credit Market: Minimization of Transaction Cost and Risk.
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As part of the *Steering Committee on Micro-Finance & Poverty Alleviation (Eleventh Five Year Plan),* it has been decided to constitute a **Working Group on Development of Competitive Micro-Credit Market: Minimization of Transaction Cost and Risk.**

The composition of the *Working Group* is as follows:

Dr. Arvind Virmani –**Chairman**
Pr. Adviser , Planning Commission

Members

1. Shri Vijay Mahajan
2. Shri Prabhu Ghate
3. Chairman, Syndicate Bank
4. Shri Nachiket Mor, ICICI
5. Shri Kunel Prem, IRDA
6. Smt. P. Gopinath, Department of Posts
7. Dr. Vijayaditya, NIC
8. Adviser (HUD), Planning Commission
9. Adviser (RD), Planning Commission
10. Shri Rohit Sarkar, Spl. Consultant, Planning Commission.

Terms of Reference:

(i) To review the formation of SHGs by multiple agencies.
(ii) To examine the current practice of providing grant under micro-credit/ credit linked subsidy by the Ministries.
(iii) To review controls and regulations that increase transaction cost/increase risk.
(iv) To liberalize interest rates on thrift and credit vis-à-vis micro finance.
(v) To develop bank-post office linkage for micro finance services of credit, deposit and money transfer.
(vi) To establish an efficient micro-finance delivery system, incorporating the use of information technology (IT).

The expenses towards TA/DA of the official members in connection with the meetings of the Working Group will be borne by the respective offices. Non-official members will be entitled to TA/DA as admissible to Grade I Officers of the Government of India and this expenditure will be borne by the Planning Commission.

The *Working Group* shall submit its report by September, 2006.

[Sharat Kumar]
Director

To,

The Chairman & Members of the Steering Committee.
The Chairman & Members of the Working Group.

Copy also to:

1. P.S. to Deputy Chairman, Planning Commission
2. P.S. to MOS, Planning Commission.
3. P.S. to all Members of Planning commission
4. P.S. to Member-Secretary, Planning commission
5. P.S. to Secretary (Expenditure)), Ministry of Finance.
6. P.S. to Secretary, Ministry of Home Affairs.
7. Advisers/Head of Divisions, Planning Commission.
8. Plan Coordination Division, Planning commission.
9. Admn/.Accounts/General Branches, Planning Commission.
10. IFA Unit, Planning Commission
11. Information Officer, Planning Commission.