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MICRO-CREDIT MARKET IN INDIA: A STUDY BASED ON THE REPORT OF PLANNING COMMISSION AND THE ELEVENTH FIVE-YEAR PLAN

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ABSTRACT

This paper is descriptive in nature and tries to understand organised and unorganised micro-credit market in India. It explores the hurdles of the flow of credit to the poor. Despite wide network of rural bank branches poor could not be brought under financial inclusion. It talks about interest rates and reliability, recovery risks and cost of funds to MFIs. The microfinance institutions reach roughly one fifth of the poor households.

It is considered that MFIs charges a higher rate of interest than formal banks but the rates charged by them are not higher as they provide credit services and many other services at the door step of the poor.

It is concluded by the M-CRIL that 24% interest rate is a reasonable one for MFIs to charge from clients to make MFIs economically viable and sustainable.

INTRODUCTION

India lives in her 6.38 lakh villages with 24 crore poor engaged in micro enterprises.[1] As per the Government of India's Ministry of Micro, Small and Medium Enterprises (MSME) annual report of 2008-09, there are 133.68 lakhs micro enterprises in India. Poverty in India is widespread with the nation estimated to have a third of the world's poor.[2] The credit needs and other financial services are provided to the rural masses in general and to the poor in particular through the rural financial markets comprising of unorganized sector consisting of commission agents, moneylenders, landlords and the like and an organized sector consisting of pyramid type cooperative credit institution – broadly classified into urban credit cooperatives and rural credit cooperatives. The urban credit cooperatives are also known as Urban Cooperative Banks. The urban cooperative banks aim at meeting the credit requirements of the people living in urban areas. The rural credit cooperatives may be further divided into short-term credit cooperatives and long- term credit cooperatives. With regard to short term cooperatives, at the grass root level there are Primary Agricultural Credit Societies (PACS) dealing directly with the individual borrowers. At the central level (district level) District Central Cooperative Banks (DCCB) function as a link between the primary societies and State Cooperative Apex Banks (SCB). As against the three tier structure of the short-term credit cooperatives, the long term cooperative credit structure has two tiers with many states with Primary

Cooperative Agriculture and Rural Development Banks (PCARDB) at the primary level and State Cooperative Agriculture and Rural Development Bank at the state level. At the national level there is the NABARD to organize the agricultural cooperatives. Also there is National Cooperative Union of India, as an apex institution at National Level. There is overlapping, duplication and dichotomy of functions within organized markets. The poor, however heavily depend on unorganized sector of credit like traders, landlords, moneylenders and the like.

The unorganized credit sector has a number of plus points such as prompt supply of credit, no formalities, no security or collaterals with excellent recovery results. The dark side of the unorganized credit sector is limited credit supply and exorbitant interest rates. The organized sector provides credit at a comparatively cheaper rate of interest but with lot of hassle such as time consuming and cumbersome loaning procedures, unrealistic lending policy leading to a lot of paper work, inadequate and untimely finance, higher transaction costs both for borrowers and the lenders along with poor recovery result.

The inability of the organized sector in maximizing the outreach can be gauged from the fact that cultivators possessing assets less than Rs. 5000 still borrow 62 percent of their total debt from informal markets.[3] Apparently this is mainly because of higher transaction costs involved in covering the large number of small sized loans on the one hand and the inability of the hard core poor to offer suitable/ acceptable security or collaterals.

The poor recovery rate of formal rural financial markets has further aggravated the situation by impairing their already fragile viability. In order to enlarge the flow of credit to the hard core poor, the NABARD launched a scheme of organizing them into Self-help groups (SHGs) and linking the SHGs with banks in 1992. The scheme is broadly on the pattern devised by the Bangladesh Gramin Bank. Under the scheme, poor preferably the women are organized in the SHGs and banks are financing these SHGs for lending money to those poor who are eligible for concessional refinance from the NABARD.

There are three distinct modes to route the credit to micro enterprises. Under the first mode, banks lend directly to the SHGs for lending to micro entrepreneurs. Under the second mode, banks provide loans to the NGOs for lending to the SHGs and ultimately to the micro entrepreneurs. Under the third mode, banks extend credit to the SHGs with the NGO as the facilitator.

Keeping pace with the banks, the Government of India has taken a number of steps to alleviate the rural poverty. A number of programmes have been designed to augment the flow of credit to the poor with varying degrees of implicit and explicit subsidies. The main thrust of these credit programmes has been the provision of financial assistance to the poor at concessional rate of interest coupled with capital subsidy to enable them to rise above poverty line.

In pursuance of this policy, commercial banks are now required to provide 40 percent of the net bank credit to the priority sector, which includes agriculture and allied agricultural activities and village and cottage industries.

Certain operational issues like cumbersome procedures in sanctioning of loans and insistence on collaterals restrict the flow of credit to the poor. The significant expansion in the branch network does not appear to have taken into account the specific needs of the poor. Physical constraints and high transaction costs restrict their access to formal credit institutions.[4] At one stage, the co-operative credit institutions in the country were considered the only option to bridge the credit gap. However, the poor could not derive the intended benefits from the co-operatives mainly because the size of these societies was too large and people of diverse interests were grouped together. Economic and caste barriers were too strong for the people to work together a one cohesive unit.

Despite a wide network of rural bank branches in the country for implementing credit-linked poverty alleviation programmes, a large number of poor people continue to remain outside the fold of the formal banking system.

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 percent in 1951 to 45 percent in 1991. Most of the benefits of this development have gone to the relatively better of people. Around 66 percent of large farmers are reported to have a deposit account, among them 44 percent have access to credit. Against this around 87 percent of marginal farmers/ landless laborers 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 percent to 60 percent. In some regions, it is reported to as high as 120 percent per annum. Despite this the non-institutional channels continue to higher sway over micro-credit in India. In a way, this is primarily due to limited outreach of the institutional sector in rural and remote areas.

Interest Rate and Reliability of Institutional Sector

Amongst the various channels under the institutional sector (formal /semi-formal banking sector), the interest rate by co-operative credit societies have been the cheapest. This is followed by interest rate 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 difference Vis-a-Vis the effective rate of interest. The better approach is to compare institutions model, for instance the microfinance institutions go to the Self Help Groups/individual borrower both for the 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 interest rate is, however, not good enough. The MFIs are concentrated in few areas driven primarily by dynamic individuals and dynamic market. In comparison to MFIs, the PACS have a much wider reach. PACS outperform both the banks and MFIs in outreach. The bank never the less, 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 facilitator-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. Bank is not allowed to make loans less then 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 costs structure (as specified by the Reserve Bank of India's circular dated January 25, 2006). Due to greater involvement of Syndicate bank and Canara bank, it is observed that more has been achieved under the SHG-bank linkage programme in the area of their Jurisdiction i.e. in the southern states.

Calculation of interest rate: comparison of flat interest rates and APR

The normal practice adopted by banking for charging interest on loans is that of 'reducing balance' or on the 'cut standing balance amount'. The MFIs, however, prefer charging interest on flat rate, as it is a simple to calculate and easier for the borrower to understand. A 10 percent per annum on reducing balance (with weekly repayments) (Table1). In other words, a high rate of interest on 'reducing balance' remains equivalent to a much lower 'flat rate' of interest.

Table 1: Comparison of interest rates:

(Loan size Ra. 1000)

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

Cost of borrowings

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 the rate of interest charged by the MFIs is the cost of funds. The MFIs depend mainly upon the fund borrowed from the commercial banks. Unlike other counters the regulatory mechanism in India prevents MFIs from accepting saving from its borrowers. The numbers 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 Sir Lanka it is1 05,168. The MFIs in India are not able to take advantage of their outreach to mobilize saving because of the regulatory mechanism. The sector is dependent on the commercial borrowings which increases the cost of funds.

According to the Ford Foundation report, the financial cost ratio (cost of found as a ratio of portfolio outstanding) is amongst the highest in the words at 8.5% whereas in neighboring 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 Sir Lanka. The operating expenses ratio of 12.3% is higher in India when compared to Bangladesh (11.9%) and Sir 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 than 100%.

RECOVERY RISK: WILLFUL AND NON-WILLFUL DEFAULTS

The formal banking sector has, in general been wary of lending to the poor because of the fear loan losses or inability to recover the loans, especially when the poor have hardly any assets to pledge as collateral. This issue has been taken care both in the case of bank-SHG linkage where the group guarantees the loan on behalf of the individual loaned. A majority of MFIs follow a similar strategy of first organizing and then lending thought SHGs. Those MFI's that follow the Gramin bank model of direct lending to people, give loans to individuals thought joint liability group especially in urban areas where there could be chances of a loan changing his/her residence (90% of MFI loaners and SHG members are women) or migrate to some other place, but the same con not happen in the case of all person constituting the 'joint liability group'. The repayments on the ground have been as high as 90-95 percent and the chances of 'willful default' have been greatly reduced.

Non-Willful Default

Group Guarantee, however, is not good enough in the case of non-willful default arising from illness (or death) or similar conditions beyond the control of the borrowers. Risk of this kind includes management risk, business risk (specific to a particulars trade) market risk, (arising from change in demand & supply /change in price), operational risk (for technological reasons) and financial risk, (arising from Interest rate change 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 loaned, 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-a vis micro-finance. It is now a general practice amongst the banks and the MFIs lending to the poor insist on the life and non-life insurance. The banks and MFls quite often set aside a certain percent of the loan amount as insurance premium to portfolio for situations arising from non-willful default. IRDA through its regulation, has not only allowed MFls /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 length of an insurances company's engagement in the Indian market) in rural areas. This measure has given an impetus to micro-insurance where there was none before.

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 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 save at very low costs, which may range between those who save and those who borrow.

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 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%.[5] it is seen that banks are able to do this business without losses even when the capped interest rates are at 12.5%. Few studies have found that lending to SHGs by some regional rural banks and commercial banks profitable.

Operating Costs of Micro Credit

The operating cost of servicing micro-credit/ micro-finance is higher than normal finance. However, this holds good for commercial banks, RRBs, MFIs and credit co-operatives. Salaries to staff travelling expenses, commissions not classified under financial costs, expenses on promotion of group staff, amortization and depreciation, welfare expenses, rent on hired buildings and other overheads-all constitute the operating cost. These costs are critical to the formal banking sector. But, it is the view that these costs need not be allocated to the SHG-bank linkage programme, since it is being incurred by the bank anyway.

Lending by SHGs is taking place at below the cost as such entire bank branches irrespective of SHG promotion mechanisms are making substantial losses. These loans are being provided at the lowest interest rates (ranges between 12.5 to 13 percent per annum) of all products. For this reason even with the most efficient operating system banks were unable to earn profits. Unless banks increase interest rates up to 24 percent, they will not be in a position to make any profits on SHG lending.

Costs to MFIs

The costs incurred by a financial institution has three components: (1) Operating Expenses (staff, travel, conveyance and other administrative costs of serving the loans) (2) Financial Costs (cost of raising money for making loans) and (3) Risk costs (risk of losing capital).

Operating Cost

Salaries moreover, account for major cost of these institutions. Efficiency of staff is of greater importance for the sustainability of micro-finance at low interest rates and efficiency depends on how many clients are dealt with by a staff member. On an average, MFIs in India are able to serve some 150-250 clients per staff member. Some larger institutions are serving more borrowers per staff member and thus getting some economies of scale. The leading ten MFls in India serve some 239 clients per staff member. This amounts to the operating ratio (OER) of these institutions declining as the size of portfolio increases.

Financial Cost

The other credit lending institutions like the MFIs and credit cooperatives may not have sufficient deposits. They are dependent on borrowing from commercial banks including the RRBs or on refinancing facility from agencies such as the SIDBI, the Rashtriya Mahila Kosh and NABARD.

In view of the high set up cost of MFIs, the development institutions may charge a lower rate of interest in initial years, which can be increased subsequently when the MFI has matured. Equity rather than grants may be the cheapest of all the 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 MFIs is thus the weighted average of all kinds of funds which are available to them.

Provision for Loan Losses (risk costs)

Generally, two percent 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.

Need for Capitalization

The interest rate charged on bank credit also plays the most important role in building 'reserves' through higher profits. A minimum capitalization is considered necessary for building the equity base retained earnings. This retained earning strengthens the institutions for both leveraging higher borrowings from banks/lenders/ as well as to attract more equity due to the ability to pay higher dividends to the shareholders. The interest rates charged by MFIs or banks are linked to the costs incurred in servicing such debts. A rate of interest between 22 to 26 percent may perhaps be most reasonable to be accepted.

In comparison with the 3-4% administrative/operating expenses incurred by banks, their average borrowers, efficient MFIs incur 10-14% Compared to average MFI client who takes loans of around of Rs. 5-6 thousand with average outstanding of just over Rs. 3,300.

M-CRIL an internationally recognized rating agency for MFIs, has recently concluded a review of 84 ratings of Indian MFIs undertaken over the past 3 years. It concluded that 24% is a reasonable rate for MFIs to charge from clients. It is sufficient costs to service the loans to larger proportions of the population and maintain some growth.

Need to charge cost-recovering interest rates

The economic viability and sustenance of MFIs depend on charging of interest rate in between 21 to 24 percent. Sa-Dhan - An association of MFIs has laid down Model Mutual Code of Conduct for Micro Finance Intuitions. As per this code interest rate of 21-24 is sufficient. The performance of the MFIs can't be judged purely on the basis of rate of interest. MFIs have several other advantages like delivery and collection of loans, outreach etc. which makes it more attractive than the formal banking sector. The MFIs deliver and collect consumer loans truly at door step and at intervals convenient to the borrower.

It is a false belief that MFIs are charging higher rate of interest than the banks, which is not true keeping in view the services provided by them. There is an urgent need for creating awareness about the need for charging cost recovering interest rates. The microfinance institutions reach roughly one fifth of the poor households and small percentage of non-poor households. Charging of cost recovering rate of interest is essential for the sustenance of these micro-finance institutions and their continued support to the poor households.

CONCLUSION

Micro-credit in India is very small in terms of percentage, which is a meagre of one percent to total lending by the commercial banks. Domestic economy is expanding and economic growth is taking place as such micro-credit has a good future. As the institutional sector which deals with the micro-credit expands, it will reduce the need of the poor to go for the informal sector for credit needs. A combined approach of micro lending by larger and more efficient MFIs and direct lending by banks to the poor can help to cover the financial needs of low income groups in India to a greater extent. Promotion of the inclusion of the majority of the population in the financial system of the country by formal banking sector is of utmost necessity.

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