ABSTRACT

The term microfinance is defined in the Indian context as “the provision of thrift, credit and other financial services and products of small amounts to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards.” There is widespread consensus that the pricing of interest and other related terms and conditions should be reasonable to clients and at the same time sustainable for MFIs and SHGs.

An MFI’s main objective is to provide the BPL (Below Poverty Line) households with a reasonable source and range of financial services. MFIs charge high rates of interest to the clients due to the high cost associated with the loan/s. The interest charged is the main source of income for the MFIs. The main factors that form basis to determining these rates are: the cost of funds, the MFI’s operating expenses, loan losses, and profits needed to expand their capital base and fund expected future growth. Keeping this in mind, not only the interest charged needs to be affordable but should also be transparent. Considering that there has been a lot of talks on issues regarding interest charged and the transparency in charging the same, this paper covers the specific issues on the same and also includes the suggestions given by the Malegam Committee.

The Malegam Committee’s recommendations and their acceptance by the Reserve Bank of India, gives rise to a number of concerns, and the constraints proposed around loan limits, interest rates and capital requirements must be revisited to avoid consequences that could impact the private sector MFIs. By suggesting a cap on the interest rates on the microloans, a panel on microfinance of the Reserve Bank of India (RBI) led by noted chartered accountant Mr Y.H. Malegam has disheveled many feathers. In one of his interviews, Mr Y.H. Malegam defended the recommendations that were laid, saying that the panel’s main intention ad duty was to protect poor borrowers and not microfinance institutions (MFIs)
OBJECTIVES OF THE RESEARCH:
Microfinance as a concept has relatively unknown globally. It has been operational and a widely respected tool for helping the poor in India for several years. The microfinance industry as a whole has developed and matured at a rapid pace in recent years. As microfinance institutions have made progress toward becoming financially sustainable, some have questioned their continued success in remaining fully committed to their social mission. Keeping all this in mind, the following are the objectives of the paper:

- To understand the concept of and need for microfinance in India
- To study the prevalent practices of MFIs in regard to interest rates, lending and recovery practices to identify trends that impinge on borrowers’ interests
- To examine the role that associations and bodies of MFIs could play in enhancing transparency, disclosure and best practices

MICROFINANCING-THE CONCEPT AND NEED
Microfinance is defined as any activity that includes the provision of financial such as credit, savings, and insurance to low income individuals which fall just above the nationally defined poverty line, and poor individuals which fall below that poverty line, with the goal of creating social value. The creation of social value includes poverty alleviation and the broader impact of improving livelihood opportunities.

The concept of microfinance was popularized through the success of Grameen Bank founded by Muhammad Yunus, tremendously in India. The growing understanding of achieving self sustainability among the rural and urban poor has led to the acceptance and implementation of this idea across India.

Microfinance loans serve the low-income population in multiple ways by:

1. Providing working capital to build businesses.
2. Infusing credit to smooth cash flows and mitigate irregularity in accessing food, clothing, shelter, or education.
3. Cushioning the economic impact of shocks such as illness, theft, or natural disasters.

Moreover, by providing an alternative to the loans offered by the local moneylender priced at 60% to 100% annual interest, microfinance prevents the borrower from remaining trapped in a debt trap which exacerbates poverty.

The range of activities undertaken in microfinance include group lending, individual lending, the provision of savings and insurance, capacity building, and agricultural business development services. Microfinance loans in India range in size from $100 to $500 per loan with interest rates typically between 25% and 35% annually.

RBI changed the definition of financial inclusion by stating that financial inclusion is not restricted merely to opening of bank accounts but must also include the provision of all financial services like credit, remittance and overdraft facilities for the rural poor.
Microfinance fills a key need in developing economies such as India as the provision of financial services to low-income clients who habitually lack access to formal banking for several reasons despite the fact that many banks are offering micro credit. The reasons could be the absence of collateral; informal employment; unverifiable credit history; and high transaction costs per rupee loaned, due to the small loan size. Microfinance loans provide financial access to the poorest that allows many of them to start new businesses, grow existing businesses, insure against shocks due to bad weather and illness, and smooth consumption. In the absence of the services provided by microfinance institutions, the poor will have no choice but to approach the unorganized local moneylenders who provide services that are fast but charge exorbitant interest rates in the range of 60-120 per cent per year and who may often also enforce repayment by illegal and manipulative means.

**PRICING OF INTEREST**

Micro Finance Institution generally levy a base interest charge calculated on the gross value of the loan. In addition, the institutes often recover a number of other charges in the form of a one time registration fee or enrollment fee.

The Interest rates charged are a function of a number of factors, of which the most prominent are transaction costs and risk figure. MFIs and other micro lenders are subject to a significantly higher transaction costs. There are three types of costs that are associated with the lending process: the cost of funds, the cost of risk which is the cost
of loan loss, and administrative costs that are incurred for identifying and screening prospective clients, processing fee of loan applications received, disbursement of loans, collecting charges, and following up on non-repayment of loans.

There is a universal agreement that the pricing of interest charges and other terms and conditions should be affordable to clients and at the same time be sustainable and feasible for MFIs. What we mean by sustainability here is long term continuity of microfinance programme that would include all the dimensions of sustainability such as institutional, market, legal and impact dimensions.

The main difficulty faced in maintaining a balance between the two is for the reason that costs of credit delivery remains more or less the same irrespective of the size of the loan, while the income that is generated by the loans vary with the size. Therefore, when a uniform rate of interest is used, larger loans yield a profit while smaller loans show a loss. This is a challenge to policy makers and regulators of the system.

Given the susceptible nature of borrowers, it becomes a need to impose some form of control in terms of interest rate control to prevent the continued exploitation. The most common form of control amongst others would be an interest rate cap but again this too has a set of drawbacks, as it could result in MFIs not providing those services where the loss is unsustainable.

As any regulator would want and strive for, there needs to be a clear balance between the two parties to the contract. This step would be unfair to the MFIs when the cost of funds is volatile and forms a large part of the interest cap. As a follow up what could be done to reduce exploitation to a certain extent in few cases, is to have a ceiling or a cap on the interest rate charged on individual loans.

Since cost of funds is a main concern for MFIs, what could alternatively be thought of is to have a margin cap. This would provide a cap on the difference in the cost of funds borne by the MFIs and the amount charged to the borrower. The advantage here to the MFIs is the fact that they are not exposed to the risk of volatility of cost of funds.

According to the report by the Malegam Committee, for the purpose of determining what would be an appropriate margin cap, it examined the financials for the year ended 31st March 2010 of 9 large MFIs, which collectively accounted for 70.4% of the clients, and 63.6% of the loan portfolio of Microfinance provided by all MFIs. They had also examined the financials for the same year of two smaller MFIs. Excerpts of the result of that analysis were as under:-

a) For the larger MFIs the effective interest rate calculated on the mean of the outstanding loan portfolio as at 31st March 2009 and 31st March 2010 ranged between 31.02% and 50.53% with an average of 36.79%. For the smaller MFIs the average was 28.73%.

b) For the larger MFIs, the average cost of borrowings calculated on the mean of the borrowings as at 31st March 2009 and 31st March 2010 ranged between 10.10% and 12.73% with an average of 11.78%. For the smaller MFIs the average cost was 11.71%
c) For the larger MFIs, the average cost of borrowings calculated on the mean of the outstanding loan portfolio as at 31st March 2009 and 31st March 2010 ranged between 8.08% and 17.72% with an average of 13.37%. For the smaller MFIs it was 11.94%.

d) For the larger MFIs, the staff cost as a percentage of the mean outstanding loan portfolio as at 31st March 2009 and 31st March 2010, ranged between 5.94% and 14.27% with an average of 8.00%. For the smaller MFIs it was 4.46%.

e) For the larger MFIs, the overheads (other than staff costs) as a percentage of the mean outstanding loan portfolio as at 31st March 2009 and 31st March 2010, ranged between 2.46% and 8.87% with an average of 5.72%. For the smaller MFIs it was 3.63%.

f) For the larger MFIs, the provision for loan losses as a percentage of the mean outstanding loan portfolio as at 31st March 2009 and 31st March 2010 ranged between 0.09% and 7.23% with an average of 1.85%. For the smaller MFIs it was 1.07%.

g) For the larger MFIs, the profit before tax as a percentage of the mean outstanding loan portfolio as at 31st March 2009 and 31st March 2010 ranged between 4.66% and 17.02% with an average of 10.94%. For the smaller MFIs it was 9.40%.

h) For the larger MFIs, the debt/equity ratio, as at 31st March 2010 ranged between 2.24 and 7.32 with an average of 4.92. For the smaller MFIs it was 5.61. If capital adequacy of 15% is assumed, the resultant ratio would be 5.67.

In considering the staff and overhead costs, three factors have to be noted and the report stated the following:

a) While on one hand the cost of the field staff may be highly variable with the loan size, on the other hand the cost of the other overheads may not vary in the same proportion. Therefore, with increase in scale, the cost as a percentage of the outstanding loan portfolio should show a considerable decline in the future.

b) In the last few years a rapid growth that has been observed in the operations of MFIs. In 2009-10 the outstanding loan portfolio of MFIs grew by 56%. To achieve this growth, what has been noticed is that there has been a rapid expansion in the branch network and development costs have been included in the staff and overhead costs. If these are not included, the costs as a percentage of the mean outstanding loan portfolio would be significantly lower.

c) Several MFIs have securitized a significant portion of their portfolio. Therefore, while the size of the portfolio is reduced, the costs remain the same as the MFIs continue to operate as means for collection for the purchasers of the securitized paper. As a result, if the rates are to be calculated on the gross portfolio, both the rate of interest on lending as well as the cost percentage would be a lot lower.
Micro Financing – Pricing of Interest as a predominant area of Concern

Based on the study, the Malegam committee report showed a normative cost structure which could form the basis for a mandated margin cap as under:

<table>
<thead>
<tr>
<th></th>
<th>% of loan portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Staff Costs (say)</td>
<td>5.00</td>
</tr>
<tr>
<td>(b) Overheads (other than staff costs)</td>
<td>3.00</td>
</tr>
<tr>
<td>(c) Provision for Loan Losses (say)</td>
<td>1.00</td>
</tr>
<tr>
<td><strong>SUB TOTAL</strong></td>
<td><strong>9.00</strong></td>
</tr>
<tr>
<td>(d) Return on Equity (say): 15% post tax i.e. 22.6107 % on 15% of loan portfolio</td>
<td>3.39</td>
</tr>
<tr>
<td><strong>TOTAL INTERNAL COST</strong></td>
<td><strong>12.39</strong></td>
</tr>
<tr>
<td>(e) Cost of Funds (say): 12% on borrowings i.e. 85% of 12% of Loan Portfolio</td>
<td>10.20</td>
</tr>
<tr>
<td><strong>Total of Internal and External Costs</strong></td>
<td><strong>22.59</strong></td>
</tr>
<tr>
<td><strong>ROUNDED OFF TO</strong></td>
<td><strong>22.00</strong></td>
</tr>
</tbody>
</table>

Keeping all this in mind, it was hence mandated that the margin cap should be segmented into two, one for those MFIs with loan portfolio exceeding Rs 100 crores and the other for those MFIs that have a loan portfolio not exceeding Rs 100 crores. Therefore according to the suggestions given the margin cap mandated for the two segments were 10% over the cost of funds for the larger MFIs that are those with a loan portfolio exceeding Rs. 100 crores and 12% over the cost of funds for the smaller MFIs that are those with a loan portfolio not exceeding Rs. 100 crores. The calculation of the cap would be on the average outstanding portfolio, hence reducing the risk of volatility of cost of funds. The justification of considering a slightly low margin cap in the context of the present cost structure as per the report was as follows:

a) It is not mandatory that the cost of development and expansion that is included in the present costs needs to be borne by current borrowers.

b) With an increase in the size of the operations, there would be a consequent reduction in the costs in future due to the advantage of economies of scale.

c) As per observation, in the last few years, the growth of MFIs has been financed out of interest charged to borrowers. Along with it they have also made profits which are in excess of the expected reasonable amount, given the susceptible
nature of the borrowers. This leads to the fact that the MFIs have the capacity to absorb these higher costs till the time the growth rates stabilize.

The above note was for the aggregate level but is not applicable to individual loans. To facilitate effectual monitoring by the regulator on the basis of the yearly financial statements, the institutions must be given the freedom to develop different individual products and price them differently as also apply different rates in different regions so long as the aggregate margin cap is maintained. Any form of action from the regulator would be necessitated if after examining the Annual Financial reports, the regulator finds that the average margin has exceeded the decided “margin cap”. The report mentioned that several options were available citing instances as verbatim are mentioned below:

   a) In terms of keeping the excess income part, the MFIs could be allowed that. The excess income could be adjusted in determining the interest rate structure in the succeeding year
   b) A Borrower Protection Fund can be created by the regulator and the MFI may be asked to transfer the excess income to the Fund.
   c) Access to priority sector loans may be suspended for a period of time and during that time to keep the MFIs business running, commercial loans could be given.

In addition to the overall margin cap, there should be a cap on the individual loans to the extent of 24%.

What the Malegam Committee recommended based on its observations was that there needs to be a “margin cap” of 10% in respect of MFIs that have an outstanding loan portfolio of Rs. 100 crores as at the beginning of the year and a “margin cap” of 12% in respect of MFIs that have an outstanding loan portfolio of an amount not exceeding Rs. 100 crores at the beginning of the year. The committee also recommended that there needs to be a cap of 24% on individual loans.

According to the data shown below, as per MIX Microfinance May edition, it is seen that most of the MFIs have been well within 26% interest rate levels till 2009, though margins have crept 1-2 percent higher than what the RBI has mandated.
Table 1

![Chart showing fiscal year and measure names with median cost of funds, median margin, and median yield on gross loan portfolio, nominal values over time.

Source-MIX Microfinance World - May 2011

Table 2 - The table below shows the number of MFIs that comply with the interest rate and margin cap provisions in each class over time.

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Large Yes</th>
<th>Large No</th>
<th>Small Yes</th>
<th>Small No</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>2</td>
<td>3</td>
<td>20</td>
<td>16</td>
</tr>
<tr>
<td>2006</td>
<td>6</td>
<td>3</td>
<td>18</td>
<td>14</td>
</tr>
<tr>
<td>2007</td>
<td>6</td>
<td>5</td>
<td>24</td>
<td>20</td>
</tr>
<tr>
<td>2008</td>
<td>9</td>
<td>7</td>
<td>28</td>
<td>18</td>
</tr>
<tr>
<td>2009</td>
<td>7</td>
<td>14</td>
<td>26</td>
<td>31</td>
</tr>
</tbody>
</table>

Source-MIX Microfinance World - May 2011
Micro Financing – Pricing of Interest as a predominant area of Concern

Table 3 - The following charts compare yield, cost of funds and margin metrics for small and large MFIs

Source-MIX Microfinance World- May 2011

TRANSPARENCY IN INTEREST CHARGES

One aspect that stands out clearly is that it is mandatory that there needs to be transparency in the interest charged by the MFIs. In general, MFIs levy a base interest charge which is calculated on the gross value of the loan. Apart from base interest charge, they often levy a variety of other charges like upfront registration or enrolment fee, loan protection fee, insurance premium etc. To make interest pricing transparent, there should be a common format for all MFIs so that all stake-holders in the industry including borrowers, lenders, regulators, etc. would have a better understanding of comparative pricing by different MFIs.
Therefore, it has been recommended that in addition to insurance premium MFIs should levy only two charges which includes upfront fee towards the processing of the loan not exceed 1% of the gross loan amount, and an interest charge.

To increase transparency and to make comparisons possible among MFIs, the borrower must know about the basic terms used like effective interest rate on the loan, repayment terms, etc. To make these terms understandable to the borrowers, a loan card should be issued in the local language and includes all these terms and the sufficient details to identify the borrower’s category as SHG/JLG to which they belong. This card should also be used as a proof for acknowledgements for each installment paid by the borrower and the final discharge, duly authenticated by the lender. Each MFIs must displayed the effective interest rate charged by them in their offices and in literature issued by them and on their website.

Insurance premium should be mandatory only to protect the MFI in the unlikely event of the death of the borrower during the pendency of the loan but not beyond this and the premium should be as a part of the loan repayment installment and not upfront. There should be a policy for the proper clearance of the proceeds in the event of the death of the borrower or maturity of the policy or for its assignment on the settlement of the loan and no administration charges should be levied.

Though the acceptance of security deposit is not permissible by the RBI Act, even than some MFIs takes a security deposit in cash from the borrowers and no interest is paid on this deposit. This deposit is taken up front from the amount of the loan; and this amount also charged interest on the gross value of the loan where as only the net amount is disbursed. The acceptance of such deposits distorts the interest rate structure and should be discontinued.

MFIs should use a standard form of loan agreement to improve transparency and comparability.

CONCLUSION

Over the last three decades, microfinance as a concept has evolved. Microfinance initially started as a simple idea that meant to provide loans to the poor but today it is a dynamic sector, including institutions that provide not only the traditional savings and remittance services but also sell insurance and offer loans for a wide range of purposes. The sector is bound together by a focus on bringing financial services to those who do not have an access to the formal banking system. In providing services, microfinance providers face both new opportunities and trade-offs.

Since Microcredit remains a high cost operation, interest rates are significantly high. Policymakers can bring a reduction in interest rates through various ways such as improved market competition, innovation, effectiveness and efficiency.

The advent of MFIs in the Microfinance or Micro Credit sector appears to have resulted in a significant increase in reach and the credit made available to the sector. Between 31st March 2007 and 31st March 2010, as per the Malegam Report, the number of outstanding loan accounts serviced by MFIs has increased by 165%, from 10.04 million
to 26.7 million and outstanding loans by 382%, from about Rs. 3800 crores to Rs. 18,344 crores.

While the above growth is impressive, a number of studies undertaken both in India and abroad have given rise to the question whether growth alone is effective in addressing the increasing poverty and if so then what are the adverse consequences of a humungous growth?

REFERENCES