Draft note: Comments welcome

Interest Rates on Micro-Credit in India: A Note

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This note puts together the existing evidence on high levels of interest rates on micro-credit loans in India. It argues that if micro-credit is to be considered as the most important method of provision of formal sector credit to the poor – as is the case now with the banking policy in India – it would imply higher average costs of credit for poor borrowers than in the past.

As is well known, both formal and informal institutions are active in rural credit markets in India. The formal institutions of credit provision, mainly commercial banks, have emerged as important sources of finance to rural households since the 1970s, as a result of the pursuit of the policy of social and development banking. Provision of credit to the rural poor, however, has continued to be under the dominant hold of informal institutions.

A major feature of credit from informal institutions to poor households is the high rate of interest at which loans are advanced. These rates of the informal institutions are much above the rates charged by their formal counterparts. Though the interest charged by the informal institutions, such as moneylenders, traders, big landowners varies across regions and villages, and can sometimes be an implicit or a concealed charge on the borrowers, it has more often than not been found to range above 20 per cent per annum, going as high as even 100 per cent per annum at times.[1] Increasing the flow of bank credit to the poor and underprivileged sections at *affordable rates of interest* was an important component of the policy of social and development banking followed in India after 1969.

In recent years, the policy of social and development banking as a whole has come under sharp criticism from the proponents of financial liberalisation. Needless to say, this has meant an attack on the administered regime of interest rates. The simple argument advanced by the proponents of financial liberalisation has been that in order to improve the profitability of the operations of the banking system, banks should be given a free hand to charge the rates of interest as determined by the market forces of demand and supply. In other words, subsidies on interest rates need to be eliminated. This idea was exemplified in the Committee on Financial System of 1991, which provided guidelines for liberalisation of the banking system. The committee noted, "easy and timely access to credit is far more important than its cost and hence… it would recommend that concessional rate of interest for priority sector loans of small sizes should be phased out" (RBI, 1991, p.48). It also noted, "lending to preferred sectors should be encouraged... by permitting commercial rather than concessional rates to the erstwhile constituents of the priority sector" (p.48). Further, it argued, "the medium term objective should be to move towards market determined interest rates" (p.50).

That the above viewpoint is now part of official policy is evident from a booklet on micro-credit brought out by National Bank for Agricultural and Rural Development (NABARD) in 1997. The booklet notes that the argument that "rural poor... need credit on concessionary rate of interest and soft terms" is a "myth" (p.8). The "reality" is that "rural poor... [are] not much concerned with cost of credit, but want timely and adequate credit" (p.8).

It is in such an environment of financial liberalisation that the concept of micro-credit has been introduced in India as a channel to deliver credit to the poor. Contrary to the models developed on the lines of the Grameen Bank of Bangladesh and tried out in other countries, in India, the public banking network has been involved in the provision of micro-credit to the poor through its linkages with Self Help Groups (SHGs). A paper by National Bank for Agricultural and Rural Development (NABARD) has referred to the Indian policy on micro-credit as "relationship banking", as compared to "parallel banking" in other countries (Jayaraman, 2001, p. 18). Public banks adopt the approach of group lending and peer monitoring for lending to the SHGs. Such a policy has three variants that differ in the mode of linkage between the banks and borrowers; all three have been encouraged by NABARD for the provision of micro-credit in India (*ibid.*).

In Variant I, the public bank acts as a Self Help Group Promoting Institution (SHPI) that "takes initiatives in forming the groups, nurtures them over a period of time and then provides

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[1] A number of villages studies in the past and in recent times from all over the Indian countryside, have highlighted the high rates of interest charged on informal sector loans to poor households. For example, see Sarap (1991), Nagaraj (1981), Roth (1983), Ramachandran (1990), Ramachandran and Swaminathan (2002).

credit to them after satisfying itself about their maturity to absorb credit".[2] In Variant II, public banks and SHGs are linked through facilitating agencies, which are either Non-Governmental Organisations (NGOs) working locally or government agencies.[3] It differs from Variant I as the formation and nurturing of SHGs is the responsibility of the facilitating agency. Direct loans are provided to the group by the banks after they gain confidence about the viability of lending to the group. In Variant III, both the facilitating and intermediating functions are played by the NGOs. The functions of forming groups, nurturing them and providing credit to them are performed by NGOs, while banks confine themselves to providing credit to NGOs. According to NABARD, this variant is practiced in regions where the banks "are not in a position to even finance SHGs promoted and nurtured by other agencies".[4]

The available data on SHGs show that the number of SHGs formed through public banks has grown rapidly in the 1990s, particularly during the second half of this decade (Table 1). Among the three variants, Variant II has been the most numerous (Puhazhendi and Satyasai, 2000). Nearly 70 per cent of the total SHGs were of the kind of Variant II, while 16 per cent and 14 per cent of the groups belonged to Variant III and I respectively. Nevertheless, an evaluation paper by NABARD makes the point that Variant III "is likely to be found more convenient by banks for credit linkage in the coming years, when very large number of SHGs would be required to be linked by small sized branches of banks" (*ibid*, p. 17).

On the question of rate of interest, the official policy on micro-credit has not displayed any deviation from the views held by the proponents of financial liberalisation discussed earlier. As the RBI's task force on micro-credit has noted:

> "past experience shows that dollops of sympathy in the form of subsidy and reduced rate of interest have not helped matters much. Micro-credit has to be commercialised where all patrons – Micro Finance providers, intermediaries, NGOs, facilitators and the ultimate clients - must get compensated appropriately... The cell believes that freedom from poverty is not for free. The poor are willing and capable to pay the cost" (RBI, 1999b, p.12).

2 See http://www.nabard.org/roles/mcid/shglinkbank.htm.

3 Some examples of government agencies acting as a facilitator for the formation of SHGs are the District Rural Development Agency (DRDA) in Andhra Pradesh, the District Women Development Agency (DWDA) in Rajasthan and Zilla Parishads in Karnataka. For details, see Jayaraman (2001, p. 31-32).

4 See http://www.nabard.org/roles/mcid/shglinkbank.htm.

According to NABARD, rate of interest for SHGs should be "market related" (NABARD, 1997, p.11). In line with this approach, the Monetary and Credit Policy for 1999-2000 has stated that "while small loans directly given by banks will continue to be subject to the interest rate ceiling as prescribed by the RBI from time to time, interest rates applicable to loans given by banks to micro-credit organisations or by these organisations to their members/beneficiaries will be left to their discretion" (RBI, 1999a, p. 13). The question that follows then is: what have been the actual rates of interest on micro-credit in India? We now put together the available empirical evidence, *albeit* limited, for answering this question.[5]

Table 1 *Number of Self Help Groups formed by public banks and loans provided, India, 1992-93 to 2000-01*

Year	Number of SHGs	Bank loans provided (in Rs. crore)	Refinance (in Rs. crore)
1992-93	255	0.29	0.27
1993-94	620	0.65	0.46
1994-95	2122	2.44	2.13
1995-96	4757	6.06	5.66
1996-97	8598	11.84	10.65
1997-98	14317	23.70	21.39
1998-99	32995	57.07	52.09
1999-00	114775	192.98	150.13
2000-01	263825	480.87	400.74
2001-02	461478	1026.34	796.00

Source: Annual Reports, 2000-01 and 2001-02, Table 7.1, NABARD, Mumbai.

The available evidence shows that allowing the rates of interest to be determined by the market has led to significantly higher costs of credit for poor borrowers. One important reason for higher rates of interest is the practice of charging margins at different levels of the credit chain. A review study indicates that the final rates of interest on micro-credit turn out to be in the range of 24-36 per cent per annum (Srinivasan, 2002; see Table 2 below). This was true for all three variants of the linkage programme examined in the above study. The reason for such high rate of interest was the margins charged by the banks, SHGs, and the NGOs (for Variant III).

[5] Micro-credit programmes and schemes implemented across various countries have so far been widely studied. However, these studies have mainly discussed the targeting and repayment performance under micro-credit. The studies that have delved into the issue of interest cost for poor borrowers under micro-credit are very few and hence, the evidence limited. For a review of the available evidence, see Chavan and Ramakumar (2002).

Srinivasan's account offers a kind of indicative picture of the interest rate structure on loans under micro-credit in India. It stands close to evidence presented by other researchers. Malcom Harper's (1998) work on 19 "typical" SHGs across India in 1997 gave the following results:

1 SHG charged 18 per cent per annum

9 SHGs charged 24 per cent per annum

5 SHGs charged 30 per cent per annum

1 SHG charged 36 per cent per annum

1 SHG charged 50 per cent per annum

2 SHGs charged 60 per cent per annum

Table 2 *Rates of interest charged by different intermediaries in the provision of micro-credit in India, 2002*, in percentage per annum

	Credit chain	Rates of interest, in per cent per annum		
		Variant 1 (Bank→SHG)*	Variant 2 (Bank→SHG, through NGO)#	Variant 3 (Bank→NGO→SHG)
1	NABARD refinance to bank	7.5	7.5	7.5
2	Bank to SHG	12 - 14	12 - 14	-
3	Bank to NGO	-	-	10 - 10.5
4	NGO to SHG	-	-	12 - 24
5	**SHG to members**	**24 - 36**	**24 - 36**	**24 - 36**
6	Margin for bank	4.5 - 6.5	4.5 - 6.5	2.5 - 3
7	Margin for NGO	-	-	2 - 14
8	Margin for SHG	10 - 24	10 - 24	6 - 12

Source: Adapted from Srinivasan (2002).
Notes: * - Banks do not charge for the formation of the SHG.
- NGOs, which facilitate the formation and linkage of groups, are not reimbursed their costs.

In another study of 35 SHGs across India, Harper (2002, p. 29) noted that 31 out of 35 groups (89 per cent) charged 2 per cent a month or more (*i.e.*, 24 per cent per annum or more) and some of them charged even 3 to 5 per cent per month (*i.e.*, 36 to 60 per cent per annum).

In a review paper on SHGs under the Maharashtra Rural Credit Project, Raghav Gaiha (2001, p. 135) noted that the average interest rates were 2 to 3 per cent per month (*i.e.*, 24 to 36 per cent per annum). Two other review papers also gave similar results (Seibel and Dave, 2002; Kropp and Suran, 2002). Seibel and Dave (2002) noted that “SHGs mostly lend at effective rates of 2% per month or 24% (real: 19.3%) per annum” (p. 30). Kropp and Suran (2002) also noted a similar range of interest rates: “the interest charged for internal lending to members ranges from 24 % - 36 % as a flat rate” (p. 22). In fact, they added that “interest rates could be increased to reflect higher cost in serving SHGs at their doorstep more regularly” (*ibid.*, p. 45).

Official studies from NABARD also present a similar picture. From a study of 70 SHGs in Tamil Nadu in 1996-97, Puhazhendi (2000) presented the following results:

> “the interest rates charged varied widely among groups. About 51 per cent of the groups had charged 3 to 5 per cent per month [36 to 60 per cent per annum] during the initial period, which was reduced to 2 to 3 per cent per month [12 to 36 per cent per annum] after a period of 3 years. In 21 per cent of the groups, the interest rate fixed was 1.5 per cent per month [18 per cent per year] … in the case of remaining 28 per cent of the groups, a uniform interest rate of 3 per cent per month [36 per cent per annum] was charged for all the purposes right from the beginning” (pp.27-28).

In another study of 60 SHGs and 115 borrowers in Orissa, Jharkand and Chattisgarh in 2001, Puhazhendi and Badatya (2002) noted that “the average interest rate charged on the loan out of the group savings was reported at 2.56 per cent per month” (p. 14) or 31 per cent per annum.

Another study by NABARD noted slightly lower rates of interest on SHG loans. Puhazhandi and Satyasai (2000), in a study of 560 households belonging to 220 SHGs in 11 States in 1999, argued that “there was an unmistakable tendency for the interest rates at which members were borrowing to converge towards the range of 12 to 24 per cent” (p.37). Their data, however, presented an interesting result, which the authors chose to overlook. The quote given above is regarding loans from all sources of loans taken together. From their data, when borrowings from public banks alone before and after 1999 (their reference year) are extracted, we get the result presented in Table 3.

The table shows a sharp fall in the number of loan accounts disbursed at less than 12 per cent per annum. The same was true for the loan amount also. On the other hand, the number of loans at rates between 12 and 24 per cent showed a striking rise after 1999 – from 37.2 to 66.7 per cent. As for the loan amount, the share rose from 55.7 to 62.0 per cent. As the size class of 12 to 24 per cent is very large, and as their paper does not provide any data by smaller size-classes, it is difficult to gauge the rise in the interest rates within this range.

Table 3 *Share of loan accounts and loan amount, by interest rate classes, Puhazhendi and Satyasai study, 1999,* in per cent

Size-class of interest rate (%)	Share of number of loan accounts		Share of amount of loans disbursed	
	Before SHG	After SHG	Before SHG	After SHG
Up to 12	62.8	33.3	44.3	38.0
12 to 24	37.2	66.7	55.7	62.0
All classes	100.0	100.0	100.0	100.0

Source: Puhazhendi and Satyasai (2000), Appendix 6.7.2.

A few studies of NABARD have concluded that the introduction of SHG-linkage programme has reduced the transaction costs of lending for banks (see Puhazhendi, 1995). This, they have argued, has occurred due to the transfer of many responsibilities of loan provision and monitoring to different Self-Help Group Promoting Institutions (SHPI). As high transaction costs was one of the major reasons for lower profitability of banks in the earlier periods, profitability levels have risen under the new policy. This argument, however, is misleading. The transaction costs of banks calculated by these studies do not include the costs incurred by the SHPIs in creating, nurturing, and distributing credit to the SHGs. It is not the case that the previously incurred costs on the above or similar functions have disappeared under the new SHG-linkage programme; it is just that these costs are now not borne by banks, but by SHPIs. In effect, the SHPIs have raised their levels of margin in the credit chain to meet these costs, simply passing on these transaction costs to the borrowers in the form of high interest rates.[6]

To summarise, the existing evidence clearly brings out that under micro-credit, an upward shift in the rates of interest, at which credit is made available by formal institutions to poor borrowers, is certainly underway in the Indian countryside. These rates can, in many cases, be closely compared with the rates charged by informal institutions from the poor borrowers. More evidence, however, based on micro-level studies is needed to further substantiate this point.

In the recent years, there has been a strong emphasis on bringing about a more flexible and softer interest rate regime in the Indian economy, as reflected from the stance taken by the monetary policy statements. It is, however, an anomaly of the existing interest rate regime that while it has turned out to be soft for all other categories of borrowers, it has particularly hardened for the poor borrowers, who in fact have been largely neglected by the banking sector so far.[7] The RBI has successively brought down the bank rate in the recent years, reflecting the stance of the monetary policy in favour of lower rates of interest. While the interest rate on loans below Rs 2 lakhs from commercial banks are subject to a ceiling of the Prime Lending Rate (PLR), banks are now free from any interest rate regulation regarding loans above this amount. In fact, in order to create a more competitive environment, banks can now advance loans even at sub-PLR rates. The PLR of major public sector banks has remained in the range of 11 to 12 per cent per annum since 1999-2000 (RBI, 2002). The nominal interest rate on loans of different types from one representative bank – the State Bank of India – is given in Table 4. The types of loans given in Table 4, faced mostly by financially better off sections in urban India, are advanced at an interest rate in the range of 8.75 to 13.5 per cent per annum. In contrast, the rates of interest ranging above 24 per cent per annum for poor borrowers under micro-credit are indeed startling.

A high rate of interest on loans is effectively a burden on the incomes of the poor. Furthermore, given the low capital intensity of investment made through micro-credit and the resultant low profit margins, high rates of interest dampen the possibility of any significant saving for the poor borrowers.[8] As poor largely borrow to meet consumption-related requirements, they feel the burden of high interest rates even more strongly. Hence, the professed objective of micro-credit of providing means to free the poor from the clutches of poverty gets defeated as the cost to be borne for such a freedom itself turns out to be onerous for them.

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[6] The passing on of higher administrative costs as higher interest rates to borrowers is a phenomenon noted for micro-credit institutions across the world. For a review, see Chavan and Ramakumar (2002).

[7] In order to encourage exports, commercial banks have been asked to advance rupee export credit under both pre- and post-shipment types, at sub-PLR rates from May 2001 (*ibid.*). The effective interest rate, taking into account the forward premium on export proceeds, has in fact declined to 2 to 3 per cent by 2001-02. The corporate sector is able to access banks' funds at increasingly cheaper rates of around 6 per cent per annum in recent years through instruments like the Commercial Paper (Majumdar, 2002).

Table 4 *Interest rates of different types of loans advanced by the State Bank of India, as on 18-06-2003*, in per cent per annum

Type of loans	Tenure/Limit/sub-type	Rate of interest per annum
Housing loans to individuals (floating ROI)	Upto 10 years	8.75
	Above 10 years	9.25
SBI car loan scheme (floating ROI)	Upto 3 years	10.25
	Above 3years	11
Education loan scheme	Upto 4 lakhs	10.85
	Over 4 lakhs	11.85
Personal loan against Equitable Mortgage of immovable property	Term loan	12
	O.D in current account	12.5
Loan for purchase of two-wheelers (SCOOM)	-	11.85
Demand loans against gold ornaments in the personal segment	-	12
Demand loans against shares and bonds	-	12.5
Festival loans (demand loans)	-	13.5

Source: < http://www.statebankofindia.com/personalbanking/pm_int.asp >, 18-06-2003.

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[8] Referring to its initiatives in providing micro-credit through SHGs, Andhra Pradesh boasts of being home to the "largest organised anti-poverty initiative in the world". According to some reports that have quoted the Andhra Pradesh Government experiment, the average saving per SHG member in 2001-02 was only Rs. 337 (Menon, 2002).

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