Micro-Finance Institutions & Interest Rates
Bank Rakyat Indonesia Shows the Way

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Main objective of Micro-Finance Institutions has been to provide financial services, more importantly savings, credit, insurance, remittances, to most vulnerable sections of the population in developing economies. However, most of the existing MFIs including public sector commercial banks in India have been endeavouring their best to provide hassle-free, need based credit on time to poor & low-income households [mostly women] so as to empower them & make econmically capable to have a comfitable living.While Micro-credit program in India has made progreesively rapid strides during last decade by providing micro-credit to more than a million Self-Help-Groups [each SHG of 10 members] pursuing their traditional economic activities, Micro-credit has its significant importance & impact if it reaches to a majority of the poorest of the poor viz, landless labourers, and rural households residing in dryland, drought prone, desert & hilly areas of the country. Besides, Micro-creditit program has tremendous potential to assist a vast majority of the marginal farmers, tenant farmers, oral lessees & share croppers to eke a living if it can finace farming activities and Small & Medium Enterprises under secondary sector of Indian economy such as, a large number of economic pursuits under the purview of Khadi & Village Industries; Handloom, Handicraft, Coir, Rubber, & Silk Boards which have over a period of time developed excellent organizational, technological & marketing infrastructure. While high interest rate on micro-credit has attracted strong criticism in India,Bangladesh, Cambodia, Pakistan & Sri Lanka an attempt is made in this paper to appreciate the rational of high interest rate charged by MFIs & suggest enabling measures to reduce the interest rate so as to make it affordable to the poorest of the poor.

Effective Interest Rate

MFIs in developing countries are reported to have been charging to their clients interest rate normally ranging from 30% to 70% per annum on a reducing balance basis. However, it is experienced that the effective interest rates in case of some MFIs are definitely higher than these rates on account of direct & indirect impact of following.

1. Commissions & fees charged by MFIs to their clients for providing specific services
2. Compulsory deposits to be elligible to obtain a loan ,
3. Frequency of repayments of loans [weekly or monthly]&
4. System, method & procedure adopted for lending & recovery of loans

It may well be appreciated that while high interest rates structure on Micro-credit has been instrumental to induce the substantial growth & development of the industry which has enabled millions of poor & low-income households to gain easy access to credit, there are still millions of poorest of the poor in the country who cannot afford to avail of such loans because of their high cost. It is precisely because of this reason that Micro-credit has yet not reached to a majority of the poorest people viz, landless labourers, and rural households residing in dryland, drought prone, desert & hilly areas. Besides, it has yet not finaced farming activities to benefit tenant farmers, oral lessees & share croppers,. It has been well established through financial analysis of the economic activities that only those borrowers who can generate sufficiently high income or returns out of their economic activities are able to pay high interest rates under the Micro-credit program. In other words, a borrower's rate of return on investment in actual practice has to be higher than the interest rate to service the loan. Such enterprises or economic activities with potentially very high margins are few in rural areas of the country. In a typical developing economy, more so in India, the best available investment opportunities for a majority of poor households generate moderate returns. Hoseholds in this category cannot be expected to have the same ability & resources to service the loans taken at high interest rates as compared to those who actually realize high returns on their investments. It is, also , a fact that more often poor households need credit to meet expenditures on health, education & consumption needs to perform social & religious ceremonies. Debts created with high interest rates often become mill-stones around their necks.It is worth researching how women borrowers are able to pay interest & loans [preferably on a weekly or monthly basis] on time in a period not more than one year, as recovery rate is reported to be around 97% ?

Cost of Lending

As MFIs provide to their clients only credit component, out of several financial services expected, the only source of their income to meet all costs is from the interest charged to their clients. MFIs in order to be initially operationally viable & in a long run to be financially sustainable have to meet all following costs inevitably.

1. Cost of funds borrowed or received from market
2. Operating costs to meet personnel & administrative expenses
3. Mandatory provision for loan losses &
4. Earn reasonable profit required to augment their capital base & fund expected for future growth.

All these four vitally essential components of costs determine the interest rate structure for MFIs.

- MFIs have to incur operating expenses for managing their operations on a day to day basis. Operating expenses cover two types of costs such as, personnel & administrative expenses. MFIs' operations being labour intensive, personnel costs are comparatively high. Administrative costs comprise mainly of rent of premises, utility charges, transport, office supplies & depreciation of fixed assets.
- Cost of lending to & recovering loan of small amounts from a large number of clients by MFIs is higher on a per unit basis as compared to commercial banks which provide high value loans to limited number of borrowers of high value collaterals in urban & metro centres.

- Staff has to visit borrowers very frequently for recovery of loans & counselling purpose which has appreciable impact on increasing costs ibecause of manhours deployed, time spent & transportation used.
- Lack or inadequacy of physical infrastructure viz. road networks, transportation & telecommunication facilities in developing economies where MFIs operate also increases significantly the overall operating costs of MFIs.
- In developing countries only a few MFIs provide microcredit in a specified geographical areas where there is no competition among them in respect of interest rates.
- Commercial banks with extensive branch network, and vast human & other resources to provide financial services efficiently have access to low-cost funds and are able to minimize operating expenses. They are presently not significantly involved in microcredit business. The lack of their participation in the financial markets also limits potential competition, inter alia, in respect of interest rate.

Impact of Interest Rate Ceiling

If attempt is made to impose interest rate ceiling at a level lower than that required to recover all costs that each MFI has to incur will have following immediate consequences.

1. Adverse impact on MFIs' willingness & ability to expand operations
2. Discourage potential investors from supporting the industry
3. Interest rate ceIling will reduce the viability & creditworthiness of MFIs, affecting their ability to borrow from the markets to finance their operations, & limit the supply of credit. This will be contrary to expectations/objectives sought for establishing MFIs.
4. Interest rate ceilings would create very high demand for microcredit in relation to its supply & mandate credit officers to adopt rationing devices that in turn create rent-seeking opportunities on one hand & some borroers re-lending to others at increased rate of interest or misutilising borrowed funds for unproductive purposes on the other.
5. If interest rate ceiling is imposed on a public sector or Government owned banks Government will have to provide funds to cover the resulting losses.
6. If MFIs are mobilizing deposits, interest rate ceiling will lower their deposit rates adversely affecting savers.
7. Interest rate ceilings depress the profitability & viability of MFIs. Accordingly, savers may be reluctant to deposit their savings. This will aggravate the institutional funding problem while curtailing a valuable service in meeting the emerging demand for credit from poor clients & assured/reliable source of domestic investment.

Cost-Reduction Strategy

Imposition of interest rate ceiling on MFIs arbitrarily is neither necessary nor desirable as it will have long term implications on the growth & development of the industry and will immediately result in reducing the supply of microcredit to millions of poor & low-income house holds who cannot have easy & reliable access to credit to make a living.It will more harm than help poor & low-income households. However, all possible efforts must be put in place by Governments & Central Banking Authorities in developing countries, more so in India,to create enabling environment, devise strategic action plan & implement it with firm determination which can help reduce interest rates progressively & sustaintially in the course of time.

1. Create an enabling environment for MFIs such that more & more MFIs are motivated to operate in one & the same geographical area to provide financial services on competitive terms.
2. Encourage entry of different kinds of institutions including commercial banks & cooperative into the industry, & lay the foundation for more competitive markets.
3. Evolve long term policy to control inflation.

4. Establish a clear & unambiguous policy assuring that interest rate ceilings on microcredit shall not be imposed. This would eliminate apprehension of a significant policy risk & encourage existing institutions to increase investments in a planned manner and new institutions to enter the market with self-confidence and improving the potential for greater market competition.
5. Create a liberal banking & financial environment so as to motivate/encourage international commercial & social investors to make equity investments in local MFIs.
6. Formulate policy for regulating, supervising & rating MFIs and authorize them to provide all financial services required by clients viz, savings, insurance, remittances etc which benefit the clients, optimally utilize human resources, increase income of MFIs & thereby reduce cost of operations.
7. Facilitate indepth research & development studies on microfinance markets to identify constraints on their sustainable growth & share findings with othe countries to evolve policy on strengthening financial viability of MFIs.

Government in particular may consider & initiate following specific measures that can facilitate MFIs reduce their costs on lending & ultimately reducing interest rate.

8. Develop the physical infrastructure focusing on improving all weather road network, transport & telecommunication facilities, human & financial infrastructure
9. Hold detailed periodical dialogue with MFIs to better understand the inadequacy of & defficiencies in physical, human & financial infrastructure that thwart MFIs'activities and formulate time bound plan & program to improve such infrastructure in a time bound plan & program. Improving physical infrastructure in as much short period as possible such as, arterial road links, bridges, transport & telecommunication system , reliable source & supply of energy & electricity will considerably improve efficiency of MFIs' personnel & clients . This will have direct & indirect impact on reducing the operating costs of MFIs.& productivity & income of borrowers Such improvements also expand economic opportunities for poor households.
10. Pay attention to improve infrastructure that specifically affects the use of new information & communication technology by MFIs, given that such technology can have a potentially significant & positive impact on lenders' operating costs. Human infrastructure improvements sharply focusing on primary & adult education system and accounting and auditing requirements will also have a significant bearing on operating costs. Better educated clients definitely help MFIs reduce their cost Thus, improvement of financial literacy among the poor & low-income households must be the top priority of the Government..
11. Governments in some countries are levying tax on the income of MFIs. Governments may consider exempting MFIs from payment of income tax but the amount equivalent to tax payment should be appropriated towards building reserves of the MFIs during the said financial year.
12. Exempt MFIs from the payment of tax the full amount provided for loan losses
13. Provide reasonable amount of subsidy to MFIs in the initial three years to make them operationally viable on lines of welfare programs implemented out of budgetary allocations.

MFIs on their own should put in serious efforts on following areas sharply focusing on reduction in interest rate,

14. Commercial banks experiencing problems to extend micro-credit directly to clients may consider providing credit to MFIs at the lowest possible interest rate as cross subsidization will help achieve social objectives too.
15. Each MFI must work out actual cost of all the four components which determinie the interest rate structure for last three years and discuss with its clients to reflect transparency of cost structure & initiate all possible measures to reduce the cost factors both in the interest of clients & MFI

16. Clients must be taken into confidence & thriugh dialogues with them 100 per cent recovery must be ensured to avoid extra provision for loan losses & reduce operational expenses.
17. There is considerable scope to optimize administrative expenses for which staff of MFIs may need to fully appreciate the concern, consider suggestions & implement them.
18. Need based training programs for clients must be held to build their capacity, improve skills & understand fundamental principles of business & financial mamagement.
19. A training program on the lines of Training Rural Youth for Self-Employment [TRYSEM] duly refined to meet changing technological requirements can be organized for the benefit of Small & Medium Enterpreneurs in consultation with KV& IC,& other institutions & Boards.

Bank Rakyat Indonesia's Experience

Bank Rakyat Indonesia [BRI] has been providing farm & micro-loans at market interest rate since 1984,after having experienced huge loan loses and over dues while implementing supply-led subsidized lending program during 1970s and early 1980s. BRI is now the largest financially sustainable intermediary in the developing world. In this context,***World Bank says" ---Program succeeded because the bank loaned at market rate, used income to finance their operations, kept operating cost low and devised appropriate savings instruments to attract depositors." "Further, the vast profits of desa unit have been used to cross-subsidize bank's other divisions' wealthier clients."***

In 1970s Indonesian Government invested huge amount of oil wealth in agriculture for developing irrigation potential, evolving rice technology, building infrastructure, providing education and health services in rural areas where 80 per cent population lived. This investment helped agriculture and rural industries support generation of rural employment, income and growth. In 1970s BRI opened more than 3500 village units to channel Government's subsidized credit to rice farmers under the country's rice intensification program during 1970s and 1980s.While the rice output increased substantially, credit components could not succeed. A large amount of subsidized loan, being at below market interest rate, was cornered by elite farmers and did not reach to poor farmers as was envisaged. Moreover, arrears and loses were high.

Financial sector reforms were extended to rural areas and Government issued first major financial deregulation package in 1983. It abolished credit ceilings and permitted banks to set their own interest rates on loans and deposits. The Government, also, decided to convert the subsidized unit desa into a sustainable system of commercial banking at the local level to extend credit at *commercial interest rate.* This made possible the transformation of BRI's unit desa system from merely an channeling agent for targeted subsidized government's loans to a profitable financial intermediary providing loans and deposit services to clients in rural areas throughout the country.

BRI's desa system, prior to adoption of commercial financial system approach, deliberated following issues very seriously and thoroughly.

- Would there be local demand for credit at interest rates needed for BRI to cover all its costs and earn a profit?
- Would people place their savings in BRI's village units?

Both these issues were researched by expert teams through intensive market surveys and it was observed that there was huge demand for credit at high rate of interest. Demand for saving services was equally very high provided the deposit instruments and services were designed to meet the needs of poor.

- .How long it would make the restructured commercial financial system to break even and begin to make profit? It achieved in less than two years as against a targeted plan of two years. BRI's approach was entirely market based which has made the system profitable since 1986 and without subsidy since 1987 and has a very high repayment rate of 98 per cent

BRI's desa unit provides credit to individuals as well as borrowers in groups, innovates new financial products suitable to borrowers and savers, adopts interest rate spreads that cover cost of lending and permit institutional profit, adopts innovative operating methods and information system. It has widely spread small outlets, specialized staff receiving need based training and incentives and finances entire loan portfolio from locally mobilized savings. Bank redesigned the financial services & delivery system focusing as under.

1. Unit desa offered loans up to US$ 3,400 in 1999 for any productive purpose carrying annual interest of 32 per cent, if repayment was made on time.
2. Saving instruments offered a choice between different combinations of liquidity and returns. Deposits proved to be a highly stable source of funds for lending.
3. Borrowers were offered considerable flexibility in respect of terms of loans to meet their credit needs. Loans were available for a variety of maturities ranging from three months to 24 months for working capital and investment loan for 36 months with 9 months grace period.. Repayment terms included monthly, seasonal and single payments to match borrower's generation of income and capacity to repay. Loan packages of 36 variations indicating possible combinations of maturities and repayments were offered to suit varying types of credit needs of borrowers Each of these combinations was printed in the loan tables to help determine borrower's needs and make loan operations transparent, eliminate scope for corruption or favorspecial customer with liberal terms.
4. Loan application and appraisal procedure was very simple. Staff assisted in form filling, if required, visited customer to verify and satisfy about the credit management aspects. Large loans were granted with collaterals. No notarization and over due certificates required.While new borrower‘s loan was sanctioned within a week's time, repeat loan took two-three days and loan was disbursed immediately.
5. Responsibility for loan decision was delegated to village units , whereas regional offices had to de-emphasis their control minded approach and become more oriented to development and promotion of quality of business.
6. Provision of staff training helped them acquire in-depth knowledge of rural credit market and changed their behaviour and attitude towards customers. Performance based cash awards and other incentives ensured high loan repayment rates. Management and organizational system aimed at capacity building to deliver financial services efficiently to low income people with wide spread outreach throughout the country. All these had impact on continuing institutional profitability without subsidy

This approach helped BRI to be profitable and country reduce poverty from 40 per cent of the population in mid 1970's to about 11 per cent in 1996. In 1997 when the East Asian economic crisis began and poverty in the country started to rise, BRI financed poor people, who had lost their jobs, for pursuing informal sector enterprises. It, also, gave secured and tailor-made deposit services to poor people in times of crisis.

- Deposits mobilized were more than double from 7.7 trillion Ruppiah in June 1977 to 17.1 trillion Ruppiah by December 1999 with number of saving accounts having increased from 17 m to 24.2 m.
- Lending went up from 4.3 trillion Ruppiah in 2.5 m loan accounts to 6.0 trillion Ruppiah in 2.5 m accounts.
- Pre-tax profit increased from 714 billion Ruppiah to 1.2 trillion Ruppiah
- Return on assets improved from 4.9 per cent to 6.1 per cent .

Conclusions

If past experience were any guide not only the poor suffer from easy access to credit but have often to incur unusually high transaction costs to secure credit from commercial or Government owned banks due to credit rationing systems & rent-seeking practices adopted by their employees. MFIs have demonstrated that millions of poor & low income households in developing countries can have hasslefree access to micro-credit subject to interest rate based on total cost recovery. Thus, it is important to make a concerted effort to lower interest rates on microcredit. This, however, can be achieved through promoting more competitive markets, low operating costs & efficiency of MFIs rather than through Government-led adminstrative measures that undermine sustainable development & growth of MFI industry.

In Cambodia, with the initiations of several positive measures interest rate has declined from around 10% per month, on a reducing balance-basis, to 3-4% per month, on a reducing balance-basis in last five years. Similarly, the weighted average interest rate on microcredit declined from 39% per year to 35.8% per year , on reducing balance-basis, in Mongolia.