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A Research Paper on Microfinance and Rural Development (A Study of Micro Finance Pricing)

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Abstract – Rural development is primarily concerned with addressing the needs of the rural poor in the matter of sustainable economic activities. The alleviation of rural poverty can be achieved by identifying income-generating activities with a focus on micro finance as the basic input for socio-economic development. There is an existing a huge demand for tiny loans in the country, the progress of the Non-banking financial company (NBFC) microfinance institutions gathered momentum. Microfinance has now been recognized as a potent tool to address the issue of poverty, catering to a niche market earlier occupied by money lenders. Microfinance is unique among development interventions: it can deliver these social benefits on an on-going, permanent basis and on a large scale. Microfinance allows poor people to protect, diversify, and increase their sources of income, the essential path out of poverty and hunger. The objective of present study is to examine whether household access to microfinance reduces poverty. Where institutional finance failed Microfinance delivered, but the outreach is too small. There is a question mark on the viability of the Microfinance Institutions. There is a need for an all-round effort to help develop the fledgling Microfinance Industry while tackling the trade-off between outreach and sustainability. This research is based on the primary data collected from field survey carried out by the author in the villages around Pune, it covers Saswad area, Hadapsar area, Baramati area etc. The secondary data used for this study was taken from the PDCC Bank.

Key Words – Microfinance, Poverty.

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BEGINNING OF MICROFINANCE

Microfinance sector has flourished at a rapid rate over the past few years. In 1976, The Nobel Laureate Dr. Muhammad Yunus has founded the modern MFIs (Micro Finance Institutions) with laying down the foundation of Grameen Bank, Bangladesh. Today this has grown into a surging industry, involves a wide range of business models.

INTRODUCTION TO MICROFINANCE

Microfinance is the allocation of small finance to low-income groups or empowering lending groups including consumers and the self-employed persons, who lack reach to banking and financial services.

Microfinance has evolved as an economic development tool and not about sanctioning micro credit to the low income person rather its objective is to assist the low income person to move away out of poverty. It includes a variety of services like insurance, credit, savings, remittance, and non-financial services like counselling, training, etc.

SALIENT FEATURES OF MICROFINANCE:

- Borrowers belongs to the poor class of society
- Small amount – micro loans are offered
- Short time period loans
- Loans requires no collaterals
- Loan pay back is high
- Loans are taken for earning and employment generation purpose

As per the data of the World Bank, India has almost one-third of the world's poor (sustaining on one dollar a day). Presently, though many government poverty alleviation programs are implemented in India, microfinance is a major contributor to financial growth. In the past few years, this helped out amazingly in alleviating the poverty. Reports unfurls that people who have used microfinance have been able to boost their income and hence the standard of living.

LITERATURE REVIEW:

Wright (2000,p.6) states that microfinance projects "fail to reach the poorest, generally have a limited effect on income…drive women into greater dependence on their husbands and fail to provide additional services desperately needed by the poor".

Sinha (1998) argues that it is particularly difficult to calculate the impact of microfinance programmes on poverty. That's why she argues, because money is fungible and therefore it is difficult to isolate credit impact, but also because the definition of poverty, how it is measured and who constitute the 'poor' "are fiercely contested issues."

Mayoux (2001, p.52) states that while microfinance has much potentia effects on poverty have been:

- A significant contribution in credit making to increase incomes of the better-off poor, including women,
- Microfinance services causative to the smoothing out of peaks and troughs in income and expenditure therefore helping the poor to cope with unknown shocks and emergencies. **Otero** illustrates the various ways in which "microfinance, at its core combats poverty."

The objective of microfinance as per **Otero (1999)** is not about providing capital to the poor on an individual level to combat poverty, there is also has a role at an institutional level. It seeks to create institutions that deliver financial services to the poor, who are continuously ignored by the formal banking sector

Littlefield and Rosenberg (2004) state that the poor are ,generally, disqualified from the financial services sector of the economy. so MFIs have emerged to address this market failure. By addressing this gap in the market in a financially viable manner, an MFI can become part of the normal financial system of a country and so can admittance to capital markets to fund their lending portfolios, permitting them to increase the number of poor people they can reach.

Littlefield, Murduch and Hashemi (2003, p.4) state that access to MFIs can help a woman to take part in family and community decisions and better able to confront gender inequities women and empower to become more confident, more assertive.. However, woman will not be automatically become empowered just because women are clients of MFIs does.

Hulme Mosley (1996, p.128) points when they refer to the "naivety of the belief that every loan made to a woman contributes to the strengthening of the economic and social position of women". However, with careful planning and design women's position in the household and community can indeed be improved.

Zohir and Matin (2004, p.318) state that various MFI loans are employed for agricultural production, trading, processing and transport, resulting in an increase in the application of agricultural inputs and increased output of agricultural produce. This leads to enhanced employment opportunities in these sectors for the wider community and a reduction in the prices of such produce due to increased supply. Scholars also state that trading activities financed by MFIs can help to establish new marketing links and increase the income of traders, and this can lead to reduced migration due to increased employment opportunities and increased income.

OBJECTIVE:

Firstly, the objective of the research paper is to explore and analyse the various methods used for Micro finance pricing in India and abroad and secondly, the analysis of Government Schemes for Micro Finance in India.

RESEARCH METHODOLOGY:

Research Technique: In this paper Descriptive Method is applied to investigate and analyse the pricing of microfinance in Indian as well as in global perspective and to analyse the application of these pricing techniques.

In very methodical way, the research technique also specifies the contribution made by the government's schemes of micro financing in India.

Data: The secondary Data is collected and used from Government of India's annual reports (MoF), Ministry of Rural Development in the form of e-data through various different websites.

PRICING FOR MICROFINANCE

1. SETTING INTEREST RATES:

In microfinance program design, determining interest rates and service charges is a main issue. To a great extent, Effective pricing of financial services may set the success to a microfinance institution (MFI).

During the last twenty years, there have been several different models on how MFIs should fix prices. Few models of donor-financed programs determine interest rates at enormously low levels. These practices are that follow at organisations where risk erosion of loan funds and discontinued loan services exist, if donations are interrupted.

The presence of many financially viable MFIs describes that microfinance institutions, can reach a large number of loan-borrowers on a sustainable basis. An important requirement for financial viability

is charging prices for financial services are high enough to meet all of an institutionalist operations and finance costs.

There is trade-off in setting prices for financial services. While the price of lending services surges up, the numbers of loans demanded, falls down. However, it is believed that there is a highly inelastic demand for financial services among poor borrowers—i.e., a relatively high increase in interest rates causes a relatively meagre reduction in quantity of loans demanded. The inelastic price is a characteristic of the market for micro loans which has been well documented and emphasizes on one of the golden rules of microfinance: access is important to small borrowers than costs.

2. LOAN TERMS

Loan repayment design is of major importance to borrowers and lenders both. In terms of price and time, loan terms describe the process of loan repayment. The terms & conditions of a loan include:

a. Time elements:

   1. Time period of loan contract
   2. Loan Repayment Time intervals
   3. Grace period (time between loan disbursement and first repayment)

b. Price elements:

   1. Interest payments
   2. Amount of forced savings, if required
   3. Fees and commissions.

Yield on an MFI's portfolio and the real cost to the borrower is determined by the loan terms. the amount and structure of interest payments is one of the most critical element. As is elaborated below, a quoted interest rate of 3%, for instance, may generate varied levels of interest depending on how interest amounts are calculated.

2.1 Pricing of Loans

What is Annual Percentage Rate (APR)?

APR = I * n

Where,

i = IRR of the net cash flow of the loan transactions fo r the unit period

And

n = number of unit period (repayment frequency)

The IRR (Internal rate of Return) with compounding effect gives us the EIR (Effective Interest Rate) which is the European union standard and is used in a large number of countries around the world. i.e.

EIR = (1+i) n

3. CALCULATING INTEREST PAYMENTS

The amount paid by a borrower to a lending organisation in interest is determined by the stated interest rate, the method used to calculate interest. Major two techniques used are: the declining balance method and the "flat" method. The declining balance method implies lower costs on the loan borrower than does the flat method. Similarly, the declining balance method generates fewer yields on an MFI's portfolio in comparison to the flat method.

In the below sections, we will consider instances of interest determined using these two methods. We will ignore present value considerations and suppose that when a weekly or monthly rate is annualized, an Annual Percentage Rate (APR) method is applied (compounding is not considered).

3.1 Declining Balance Method

While the declining balance method is applied, the interest is calculated based on the balances which remain in the borrower's hands. As future instalments of principal are repaid, these balances reduces. In this case, no interest charged on the of the principal loan amount that the borrower has already repaid.

3.2 Flat Method

The flat method is applied when interest is calculated based on the original normal amount of the loan rather than on the reducing balances. The Computation of interest using the flat method instead of the reducing balance method has the effect of increasing the payment made each period, and, therefore, raising the "effect" interest rate to borrower. This means that the loan is relatively costly to the borrower and, equally, that the loan produces more income for the loaning institution.

All other things being equal, when interest payments are computed using the flat method, total payments by the borrower are greater than total payments when interest payments are computed applying the reducing balance method. Therefore, the flat method cultivates more revenue for the lending institution and burdens higher costs on borrowers.

3.3 The Effective Interest Rate

The effect interest rate is the rate which a client is "truly" paying, determined on the amount of loan proceeds really in the client's hands during the each period of the life span of the loan. The formula to calculate the effective interest rate is:

$$\text{Effective Interest Rate} = \frac{\text{Total interest and fees}}{\text{Average balance outstanding}} \times \frac{\text{Periods in a year}}{\text{Periods in the loan term}}$$

Applying this formula, we will compute the effective interest rates of flat interest rates and declining balance and on otherwise similarly loans.

4. OTHER FACTORS THAT DETERMINE EFFECTIVE INTEREST RATES

By changing any of the following factors, a lending institution can raise the effective interest rate of a loan (and raise the portfolio yield):

a) Needed that a portion of the loan be deposited as obligatory savings prior to or after loan pay-out.

b) Needed payment of interest at the commencement of the loan, as a deduction from the amount of principal disbursed to the borrower.

c) Levying a fee or commission in addition to the interest.

d) Needed more frequent payment of principal and interest both.

5. DETERMINING INTEREST RATES

How an MFI should decide what prices to charge from its clients? In order to achieve financial viability sustainability, income must cover all program and financial costs. Interest income from loans must cover all costs for most MFIs without other assets that provide income, Therefore, the below are crucial factors to consider when an MFI determines an interest rate:

- Administrative Expenses, rent and utilities, salaries, travel.
- Office supplies, Transportation, etc.
- Depreciation Inflation and.
- The losses and cost of loan.
- The real cost of the funds that the MFI borrows.

5.1. Real Interest Rates vs Nominal

Usually, the interest rate charged to borrowers is called the nominal interest rate. This is different from the real interest rate, which is likely calculated as follows:

Real Interest Rate = Nominal Interest Rate - Rate of Inflation

The real interest rate is positive, if the nominal interest rate is more than the rate of inflation. For borrowers, a positive interest rate means that they have really paid something for the advantage of using the funds that they have borrowed. In order to the loan fund to maintain its value, it is vital for an MFI to charge a nominal rate of interest which is more than the rate of inflation.

5.2 A Sustainable Interest Rate

A straightforward method, the **Consultative Group to Assist the Poorest** (CGAP) has designed it, to allow MFIs to decide what effective interest rate they require to charge in turn to achieve financial viability. Given Below is an overview of the calculation.

Five elements determine the interest rate required for financial sustainability (R), each articulated as a percentage of the average outstanding credit portfolio:

- Administrative Expense Rate (AER), calculated by dividing total yearly administrative expenses by average unpaid loan portfolio;
- Targeted Capitalization Rate (K), the net real profit that the MFI determines to target, divided by the average loan portfolio;
- Loan Loss Rate (LLR), computed by dividing yearly loss due to non-collectible
- Loans by average unpaid loan portfolio;
- The Market cost of funds rate (MCF), for details on computation, see the CGAP paper; and
- The Investment Income Rate (IIR), the income expected to be from an MFI's financial assets other than the loan portfolio, divided by the average loan portfolio.

Generally, The administrative expense rates of health MFIs is between 10-25%, targeted capitalization rates set between 5-15%, and loan loss rates set between 1-2%. **R**, the minimum required annualized effective interest rate for financial viability, is computed as follows:

$$R = \frac{AER + K + LL + MCF - II}{1 - LLR}$$

For a hypothetical MFI, The CGAP paper provides the following example for the interest rate calculation:

Administrative expense rate = .2, Targeted capitalization rate = .16, Loan loss rate = .02, Cost of funds rate = .21, Investment income = .015

In this example, R = (.25+.16+.02+.21-.015)/(1-.02) = .638.

CONCLUSION

The Pricing is a straight determinant of financial viability, although not the only determinant. An MFI that is able to recover its program costs and reimburse for the impact of inflated prices on the portfolio (in other words, a financially sustainable MFI) must charge more prices, generally, than an MFI that is financed by donor funds. The Studies have revealed that the most financially feasible programs differ extensively from less viable programs in their readiness to set interest rates at levels which allow to fully payback the costs.

However, this is not to say, that high pricing is a signal of a financially feasible MFI.

At Certainty, there are MFIs which are both charge high prices and are not financially viable. Furthermore, it is important to notice that many donor-financed MFIs which are not financially feasible stands-alone institutions also serve an important function. Financial suitability may or may not be a part of the objective of an MFI. Since financially feasible institutions generally charge greater prices than institutions that are not financially sustainable, some scholars wrote that financially feasible programs have not had success reaching lowest of the low of society or to poorest. The goal of augmenting credit services to the poorest households may justify continuing subsidization.

At Last, deciding an MFI's feasibility based on its ability to cover program and financial costs through interest payments is a meaningful standard only to relatively mature institutions. New microfinance works that attempt to cover all costs would be forced to charge exorbitantly high interest rates. MFIs can be expected to cover all relevant costs only after having an chance to attract a big sizable client base and also acquiring required tools for efficiency.

A microfinance organization should examine the ability of its potential clients to pay for financial services. In addition, it is important for an MFI to investigate the other financial options available to its client base. Very often, access to credit among poor and especially poor rural populations is very limited or in fact non-existent. An MFI's competitors, if they exist, may include: local moneylenders, commercial banks, and other microfinance organizations.

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