

Transaction Costs of Lending to the Rural Poor: Non-Governmental Organisations and Self-Help Groups of the Poor as Intermediaries for Banks in India

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Executive summary

The Indian banking sector has performed impressively in recent times in achieving social goals, extending the geographical reach and functional spread of financial services, especially for the rural poor. However, the viability and profitability of financial institutions, with respect to rural lending, have been eroded due to high transaction costs and poor recovery performance. In this context group lending for the poor is being recognised as an important innovation. Non-government organisations (NGOs) and self help groups (SHGs) are emerging as effective financial and non-financial intermediaries in the institutional credit delivery system in rural areas.

In 1991 the Reserve Bank of India issued a directive to all commercial banks, encouraging them to establish linkages directly with NGOs and SHGs in India, using the latter as financial intermediaries of the banks to reach the poor. NABARD subsequently issued guidelines for a pilot project to link banks with SHGs. The present study attempts to quantify the cost effectiveness of delivering credit to the rural poor through the intermediation of NGOs and SHGs, compared with direct lending.

A number of projects have operated in parallel, employing the linkage concept. These include NABARD's linkage project, actively supported by commercial banks, a women's development project implemented by IFAD in Tamil Nadu State, and the Foundation's case study in South India for **Banking with the Poor**. From this experience a number of different rural credit channels may be distinguished, as indicated below.

Model I lending directly to the rural poor (benchmark situation)

Model II lending directly to the rural poor keeping NGOs and SHGs as non-financial intermediaries

Model III where banks use SHGs as financial intermediaries and NGOs as non-financial intermediaries

Model IV where credit flows from banks to NGOs, and then to SHGs, before reaching ultimate borrowers (both NGOs and SHGs as financial intermediaries).

Since the delivery of institutional credit through these intermediaries during 1992-93 was mainly concentrated in Karnataka and Tamil Nadu, these states were selected purposively for the study. The sample frame includes two major commercial banks (Canara Bank and Indian Bank), one regional rural bank (RRB) (Chitradurga Grameena Bank), and one private commercial bank (Vysya Bank).

Transaction costs of lending, per account as well as for the branch as a whole, were estimated using the cost-allocation method. Estimates of time spent by bank personnel for the identified functions or tasks were used to calculate the cost of loan delivery per account. Transaction costs per loan account were estimated on the basis of data collected from 128 sample accounts in the selected bank branches. With a view to quantifying the transaction costs of borrowers, a sample of 150 borrowers was selected. The distribution of sample borrowers was made in proportion to the number of accounts financed by each bank. Details relating the various components of the cost of transacting a loan, and factors influencing variations in transaction costs, were collected from the sample borrowers. A simultaneous equation model, with 'transaction costs' and 'loan

demand' as endogenous variables, was used to quantify the factors influencing the transaction costs of borrowers in rural lending.

The intermediation of NGOs and SHGs considerably reduced the time spent by bank personnel in identification of borrowers, documentation, follow-up and recoveries. This in turn influenced the reduction in transaction costs of rural lending. The estimated average transaction cost of lending per account was Rs 195, constituting 3.68 per cent of the loan amount, if the loan was delivered via a direct lending channel. The intermediation of NGOs and SHGs helped banks to reduce transaction costs by between 21 and 41 per cent when compared with the benchmark situation (that is, of direct lending). Among the different models involving intermediation, Model III proved to be most efficient. The dynamic nature of the reduction in transaction costs as a result of intermediation effected a downward shift of the marginal cost curve. This was possible because of the active role played by NGOs and SHGs in identification of borrowers, follow-up and recovery, which resulted in significant reductions in the time spent on these functions.

The estimated borrower transaction cost of dealing directly with a bank, per loan account of individual borrowers, was Rs 272. Of this amount about 40 per cent was for cash expenditure, while the balance represents the opportunity cost of time spent by borrowers in negotiating loans with banks and proving their creditworthiness. The intermediation of NGOs and SHGs contributed in reducing the transaction costs of borrowers by about 85 per cent. This reduction in cost was mainly due to the elimination of expenditure on documentation procedures, and a reduction in opportunity cost, in terms of the number of visits and the time spent on bank premises.

The estimated transaction cost of intermediaries was about 2.72 per cent of the loan amount when credit programs to SHGs formed part of their total activities. The cost of intermediation by NGOs includes the expenditure on maintaining the SHG for the first year or two and for negotiating the loan with the bank.

The intermediation of NGOs and SHGs has also proved useful in improving recovery rates. While the estimated default risk was very high for direct lending under Model I (22 per cent), it was negligible under the other models where intermediation occurs.

An attempt to estimate the impact of reductions in transaction costs on the viability of banks revealed that, *ceteris paribus*, if all loans were disbursed through intermediation, regional rural bank (RRB) branches would become financially viable after wiping out current losses. Commercial banks, both public and private, would improve their viability status further. In addition, a significant reduction in default risks would have a cascading impact on the profitability of bank branches.

The results of the simultaneous equation model also supported the hypothesis that the intermediation of NGOs and SHGs has a significant influence in reducing transaction costs. The finding of a non-significant relationship between 'interest rate' and 'loan demand' confirms that borrowers are relatively insensitive to changing interest rates.

The major conclusion drawn from the study is that the intermediation of NGOs and SHGs in the institutional credit delivery system significantly reduces the transaction costs of both banks and borrowers. Consequently the viability of bank branches is improved. The success of intermediation lies in the effective functioning of NGOs, and in tapping the inherent strengths of SHGs. Periodic workshops and training programs need to be organised to disseminate to concerned parties the experience of intermediation.

An overall qualification to the conclusions of this study derives from the fact that it was conducted at a comparatively early stage of NABARD's pilot project linking banks with SHGs. This had implications for the available sample of banks and the geographic coverage of the survey. It is highly desirable that subsequent studies be conducted to confirm and extend these findings and their policy implications.