

Determinants of Interest Rate in Micro finance Groups - Theoretical Discussion and Empirical Evidence from India

Naveen Kumar K*

The microfinance programs have expanded the frontiers of institutional finance and have brought the poor, especially women, into the formal or semi-formal financial system. The programs have widened the access to financial services and equipped them to fight against poverty through the formation of microfinance groups¹. Among the many distinguished features of microfinance, compared with traditional credit system, the interest policies are described independently. Today, they represent one of the most controversial areas of concern in the microfinance industry. Thus, setting optimal rates of interest is one of the complex tasks for microfinance groups. Naturally, these institutions need to charge high interest rates to cover their costs if they are to attain financial sustainability. However, on the other hand, very high rates of interest will hamper the poverty-reducing target of microfinance. High interest rates (high

repayments) will extract a good part of the poor people's wealth accumulated through the microfinance programme. Eventually, interest rates can simply make microfinance services unaffordable and financially exclude the poor from the microfinance services.

In fact, many studies contend that the microfinance industry should give loans at more favourable rates of interest than traditional credit because it is offered to disadvantaged people. However, some studies claim that the beneficiaries of microfinance are not sensitive to interest rate because their access to credit is very high (Harper, 1998; Torre and Gianfranco, 2006). Apart from these contrasting issues on rates of interest, the present concern is to determine how the pricing of loan is decided in the microfinance industry. What, precisely, are the factors that determine the level of interest rates in microfinance groups? Hence, it is necessary to identify the indicators and

*Faculty, National Institute of Bank Management (NIBM), Kondhwe Khurd, Pune, India

¹ The term microfinance groups in India is generally used to refer to unregistered groups of 10 to 20 members (some time it will be even less than 10 member groups) involved primarily in savings and credit activities.

variables that have to be considered in fixing the rates of interest in microfinance.

In this backdrop, the present study identifies the basic factor that determines interest rate at the microfinance groups. To explore the wide range of issues in determining the rate of interest in microfinance, the subsequent section of this paper brings out a comprehensive review of the various aspects that determine interest rates in the microfinance industry.

THEORETICAL DISCUSSION

Pricing or determining the rate of interest for the loans is an important aspect of loan product design. Effective pricing of financial services may largely determine the short and long term sustainability of program. Over the course of the last two to three decades, there have been several different theories on how microfinance program should set prices. The 'donor-centred' (poverty lending) models of microfinance programs set interest rates at an extremely low levels. The institutions that followed these practices faced the risk of erosion of loan funds and discontinued loan services if donations were interrupted. The emergence of 'financial sustainability' (institutionalists) models demonstrated that microfinance program can reach a large numbers of borrowers with an

improvement in their wellbeing provided institutions are viable. An essential requirement for financial viability is that prices charged for financial services meet all operational and financial costs of the institution. Thus, a balance must be reached between what clients can afford and what the lending institution needs to cover all the fixed and variable costs.

There is an inherent trade-off in pricing of financial services. When the price of lending services goes up, the demand for loans falls. However, it is widely believed that demand for financial services among poor borrowers is highly inelastic — that is, a relatively large increase in interest rates tends to cause a relatively small reduction in demand for loans. The inelastic demand for micro loans has been well documented and explains one of the golden rules of microfinance – 'access is more important to small borrowers than costs' (Harper, 1998). If the organisation does not charge a high interest rate, it will be difficult to continue in business, which is highly detrimental to both the borrower and the community. Higher interest rates are necessary to cover the administrative costs of small loans made at locations near the borrowers (Smith and Eric, 2007). Generally, the poor households are willing and able to pay interest rates for loans that fully cover the costs of lenders. A frequently heard

argument to support this policy is that poor households are not very sensitive to higher interest rates, but they look for easy and timely access to credit services.

In microfinance, interest rate is the primary source for the financial sustainability of the program. The interest rate that the borrower pays to the institution should ideally compensate the risks associated with lending and the costs of delivering the services (Sa-dhan, 2004). Generally, the interest rates of in the program are way above that of the formal financial institutions and below that of the informal sources² (Shylendra, 2006). However, there are variations across the regions and institutions. The variations in the rate of interest are largely influenced by the cost of capital, transaction cost, and costs involved in the delivery of credit and credit-plus services. Nevertheless, the cost of delivering services is highly influenced by the prevailing market conditions, institutional structures, approaches, and their efficiency in managing the resources. Further, for a microfinance program to be a sustainable entity along with a competitive rate of interest on (lending) loans, it should be efficient in raising resources (capital) from the market at a competitive rate of interest and maintain economics of scale in its operations. Therefore, the rate of interest in

microfinance program is a key determinant of financial sustainability and wider outreach of microfinance services (Christen, 1997).

SURVEY DESIGN AND DATA

The data have come from a survey of 106 women SHGs in ten villages in the state of Karnataka, India. Five of the villages were supported by Sri Kshethra Dharmasthala Rural Development project (R.) (SKDRDP) Dharmasthala, Dakshina Kannada and the other five were supported by Sangamithra Rural financial Services (SRFS) Mysore. The rationale behind the selection of Sanghamithra is that it is the only Non-for Profit Company MFI registered under the Indian Companies Act, 1956 and working in the state for more than ten years with wide experience in microfinance services in the state of Karnataka. Sanghamithra MFI is also extends its micro-financial services in the neighbouring states like Tamil Nadu and Andhra Pradesh. However, the motivation behind the selection of SKDRDP an NGO-MFI was that it is the largest (by reaching the number of poor people and loan outstanding) NGO-MFI working in the field of microfinance in the state of Karnataka. SKDRDP an MFI is also reaching the poor with many non-financial services to the poor, through the development of micro-enterprise units, health care and sanitation facilities,

² Bank to SHG lending rate 12 per cent to 13.5 per cent. MFI to SHG lending rate 15 to 24 per cent and Moneylenders to Traders/individual 36 per cent to 120 per cent (Mahajan and Ramola, 2004).

literacy programme, etc.

To study the determinants of rate of interest in SHGs, a multi stage sampling technique was used in the selection of the units. Accordingly, at the first stage, Mysore district from the operational area of Sanghamithra MFI and Dakshina Kannada district from SKDRDP MFI is selected purposively. Selection of the district was done keeping in view that it should satisfy the two criteria viz.

(i) cover (formed/linked to the MFI) the maximum number of SHGs and rural poor households and

The district should be the first operational area so that we have matured groups and members for the study. The

second stage of sampling is the selection of taluks. There are two taluks, viz., T. Narasipura taluk and Belthangady from Sanghamitra and SKDRDP operational areas were selected by using the same criteria that was used for the selection of districts. The third stage of sampling covered the selection of villages. From each taluk, the village list was prepared with number of SHGs formed/linked to the MFI. Consequently top five villages having highest number of SHGs and members were selected from each taluk. The five villages from Belthangady taluk are Bandaru, Kokkada, Neriya, Machina and Padangady and Hykanoor, Helavarahundi, Talakadu, T.Bettahalli and Vatal from T.Narasipura taluk were selected for the

Table 1: The Sample SHGs across MFIs, taluks and villages

Sl. No	Name of the MFI / Taluk	Name of the village	Total No. of SHGs linked to MFI	Sample SHGs Selected for study
1	SRFS /T. Narasipura	Hykanoor	45	11(20.8)
2	-do-	Talakadu	46	11 (20.8)
3	-do-	Vatal	47	11 (20.8)
4	-do-	Helavarahundi	40	10 (18.9)
5	-do-	T Bettahalli	41	10 (18.9)
Total				53 (100)
6	SKDRDP/Belthangady	Bandaru	49	12 (22.6)
7	-do-	Kokkada	45	11(20.8)
8	-do-	Machina	35	9 (17.0)
9	-do-	Neriya	42	10 (18.9)
10	-do-	Padangady	47	11 (20.8)
		Total		53 (100)
	Grand Total		437	106

Note: Figures in parentheses denote percentage to the total number of sample SHGs in particular taluk

Source: Primary Survey

study. The fourth stage of sampling involved the selection of SHGs. In the each selected village, the currently MFI linked SHG list was prepared. Accordingly, from each village 25 per cent of SHGs were selected randomly. In all, 106 SHGs (53 SHGs from each taluk) were randomly selected from ten villages. The sample of SHGs by MFIs and taluks and villages is presented in the Table 1. The interview schedule (Questionnaire) was prepared and data on basic details of the group, like, age of the SHG and its size, savings, number of loans or loan cycles, cost of funds, operational costs, opportunity costs, travel cost and other cost involved were collected from the SHGs.

EMPIRICAL RESULTS

The diversity in microfinance sector has lead to differential rates of interest across the MFIs and SHGs. The determination of interest rate at the SHG level is analysed by using the information on administrative costs: --selection, monitoring and enforcement of the borrowers (it was collected through the time spent in the group meetings multiplied by the prevailing wage rate in particular village), payment for hired staff for writing the accounts, auditing, and purchase of the stationery. The information on cost of funds was gathered through the rate of interest and fees and commissions paid by the SHG to the MFI

on loans obtained. It is observed through the average loan amount multiplied by the average rate of interest of the MFI. The information on travelling cost was collected through the monetary cost incurred to visit the bank branch and MFI field office to avail information on loan, submission of application, follow-up, receiving of the cheques, and repayments. The opportunity cost of loan was calculated through the time spent on travelling in availing the loan. It was determined by estimating the value of the time the borrower spent away from his work. Care was taken to exclude visits to town not associated with the loan. The cost of each workday was calculated at the prevailing market wage rate for workers in the village. The other cost included the hospitality provided to the field officers, cost of documentation and bond papers/securities were used in getting the loan.

Generally, the costs associated with the loan, like, administrative, opportunity, travel, and other costs will vary across the SHGs and regions. It will also lead to variation in the rate of interest. In this background, the subsequent part of the analysis will bring out the influence of various cost factors in the determination of the rate of interest charged by SHGs.

Table 2: Distribution of SHGs by Number of Loan and Loan Amount Borrowed from MFIs

SHGs in Taluk's	No. of loans borrowed from MFIs	Total amount of loan per SHG (in Quartiles)			
		< 25 quartiles	25 to 50 quartiles	50 to 75 quartiles	> 75 quartiles
		Less than Rs. 93000	Rs. 93001 to Rs. 170000	Rs. 170001 to Rs. 252000	More than Rs. 252001
Belthangady	1	--	--	--	--
	2	--	1 (5)	--	--
	3	5 (55.6)	11 (55)	3 (18.8)	--
	4	4 (44.4)	7 (35)	8 (50)	1 (12.5)
	5	--	1 (5)	5 (31.2)	7 (87.5)
	Total (N=53)	9 (100)	20 (100)	16 (100)	8 (100)
T. Narasipura	1	8 (47.1)	--	--	--
	2	8 (47.1)	2 (20)	--	--
	3	1 (5.9)	8 (80)	5 (71.4)	5 (26.3)
	4	--	--	2 (28.6)	10 (52.6)
	5	--	--	--	4 (21.1)
	Total (N=53)	17 (100)	10 (100)	7 (100)	19 (100)
Total	(N=106)	26 (24.5)	30 (28.3)	23 (21.7)	27 (25.5)

Note: Figures in parentheses denote percentage of total SHGs in particular taluk.

Source: Primary Survey.

Table 2 shows that the frequency distribution of SHGs by number of loans and loan amount across the taluks. The loan amount was classified under four sections, based on distribution. The first quartiles (less than 25 quartiles) less than Rs.93,000, second (25 to 50 quartiles) Rs.93001 to Rs.1,70,000, third (50 to 75 percentile) Rs.1,70,001 to Rs.2,52,000 and fourth (more than 75 quartiles) more than Rs.2,52,001. In Belthangady taluk, 98 per cent of the SHGs had borrowed more than two times from the MFIs. Majority of them had borrowed more than four times from MFIs. However, in T. Narasipura taluk, many SHGs had borrowed less than three times from the MFIs. Only 7.5 per cent of the SHGs had

borrowed five times from Sanghamitra MFI.

It is also clear from the Table that from the total sample (106 SHGs) more than 75 per cent of SHGs had borrowed more than Rs. 93000 from the MFIs and still 25.5 per cent are SHGs were in the fourth quartile. In Belthangady taluk alone 30.2 and 15.1 per cent SHGs were in the third and fourth quartile, respectively, and a marginal number of SHGs were in the first quartile (17 per cent) in Belthangady taluk. In T. Narasipura taluk, 35.8 per cent of SHGs were in the last quartile and another 32.1 per were in the first quartile. It shows that there are equally extreme ends of very low and very high loan borrowings from MFIs. The reason behind

this uneven distribution is that the SHGs linked to Sanghamitra are from different SHPIs. It was observed that the Stree Shakthi or Swayamsidda groups were poorly managed and they had borrowed very little from the MFIs. It was also observed that as the average loan amount increases the cost of the funds also increases. The average amount of borrowings will directly influence the cost of funds borrowed from the MFIs.

The average loan amount disbursed by the SHGs in Belthangady and T.Narasipura taluk had increased over a period of time. The average loan amount disbursed by the SHGs in Belthangady taluk increased from Rs.16,796.23 to Rs.1,26,746.52 between the first and seventh year of its operation. However, in T.Narasipura taluk the average loan amount disbursed by the

SHGs increased from Rs. 18,325 to Rs.1,91,638.16 between the first and the sixth year. It is also apparent from the Table that in the initial years the amount of credit disbursed to the members was comparatively small. It was a minimum of Rs. 2,000 and a maximum of Rs. 82,000 in Belthangady and minimum of Rs. 3,000 and maximum of Rs. 80,000 in T. Narasipura taluk. However, over the years the credit disbursed has increased many folds. At the time of fieldwork, the minimum amount of credit disbursed was Rs. 30,000 and maximum of Rs. 3,13,805 in Belthangady taluk and minimum of Rs. 30,000 and maximum of Rs. 31,28,000 in T. Narasipura taluk. It shows that the SHGs are working like a 'mini bank' in the rural areas with improved access to credit services.

Table 3: Average Amount Disbursed by the SHGs and Average Rate of Interest in Belthangady Taluk

Loan Cycles	No. of Cases (SHGs)	Amount Disbursed by the SHG (Rs.)			Rate of interest per annum (percentage)		
		Average amount	Amount Range		Average rate of interest	Range of rate of interest	
			Minimum	Maximum		Minimum	Maximum
First	53	16796.23	2000.00	82000.00	19.55	16	24
Second	53	53384.06	9500.00	158500.00	19.85	16	21
Third	53	61248.11	4000.00	216050.00	17.43	15	18
Fourth	50	78145.00	13000.00	359010.00	16.26	14	18
Fifth	45	90978.53	20400.00	300000.00	15.91	15	17
Sixth	24	85267.08	26000.00	200000.00	14.75	14	15.5
Seventh	23	126746.52	30000.00	313805.00	14.50	14	15

Source: Primary Survey

Table 4: Average Amount Disbursed by the SHGs and Average Rate of Interest in T.Narasipura Taluk

Loan Cycles	No. of cases (SHGs)	Amount disbursed by the SHG (Rs.)			Rate of interest per annum (percentage)		
		Average amount	Amount Range		Average rate of interest	Range of rate of interest	
			Minimum	Maximum		Minimum	Maximum
First	53	18325.00	3000.00	80000.00	38.49	24	60
Second	53	41407.55	8000.00	125000.00	31.32	24	48
Third	47	76696.81	10000.00	220000.00	26.04	24	48
Fourth	34	90294.12	24000.00	170000.00	24.55	21	36
Fifth	27	89425.93	9400.00	225000.00	22.93	18	32
Sixth	13	191638.16	30000.00	312800.00	21.33	18	30

Source: Primary Survey

Table 3 and 4 also explains the rate at which the loans were disbursed to members. The average rate of interest in the SHGs of Belthangady taluk declined from 19.55 per cent to 14 per cent, between the first and seventh year of lending. It is apparent that the interest rate had declined for the SHGs in T.Narasipura taluk, from 38.49 per cent to 21.33 per cent. However, this rate is comparatively higher than the rate charged by the SHGs in Belthangady taluk. The Table also makes it clear that the range of interest rate charged by the SHGs in Belthangady was between 16 per cent and 24 per cent in the initial years and 14 and 15 per cent at the time of

survey. However, the SHGs in T.Narasipura charged between 24 per cent and 60 per cent in the initial years and it declined to 18 and 30 per cent at the time of survey. In the field some of the microfinance members opined that they wanted to build a corpus fund for their SHGs, hence, they were charging higher rates of interest on loans to their members as compared to other SHGs. Hence, there are two important aspects in determining the rate of interest across the SHGs. Firstly, the various cost components, and secondly, the expected margin or mark up that is fixed by the members for the development of the common fund.

Table 5: Average Loan Amount Borrowed by the SHGs from the MFI and Rate of Interest and Commission/Fees paid across Belthangady and T.Narasipura Taluk

Loan Cycles	No. of cases (SHGs)	Loan amount borrowed (Rs.)			Rate of Interest on loan (percentage)			Average fees and commission (Rs.)
		Avg	Min	Max	Avg	Min	Max	

Belthangady Taluk

First	53	21150.94	5000	88000	14.75	12	16	280.57
Second	53	39433.96	5000	130000	13.83	12	15	397.17
Third	52	51500.00	5000	125000	12.31	12	14	401.92
Fourth	33	61818.18	12000	150000	11.92	11.50	14	472.73
Fifth	13	103846.20	15000	300000	11.25	11.25	14	856.38

T.Narasipura Taluk

First	53	25566.04	15000	70000	16.08	14	17	241.13
Second	45	55222.22	25000	100000	15.71	14	16	476.14
Third	35	97314.29	30000	200000	14.51	13	16	710.00
Fourth	16	147187.50	50000	250000	14.11	12	15	1103.13
Fifth	4	157500.00	100000	200000	14.00	12	14	1250.00

Note: Avg = Average; Min = Minimum and Max = Maximum

Source: Primary Survey

It is obvious from the Table 5 that the average loan amount borrowed by the SHGs in T.Narasipura taluk was much higher than in Belthangady taluk. In the first year of borrowing, SHGs in Belthangady taluk obtained an average loan amount of Rs.21,150.94 and it increased to Rs.1,03,846.20 at the time of the survey (fifth year). However, the average loan amount borrowed by the SHGs of T.Narasipura increased to Rs. 25,566.04 to Rs. 1,57,500.00. Consequently, the average rate of interest paid by the SHGs for the loan to the MFIs had declined from 14.75 per cent to 11.04 per cent in Belthangady taluk and 16.08 per cent to 14.00 per cent in T.Narasipura taluk. However, the average fees and

commissions paid for the loans increased as the average loan amount increased. The fees and commissions are paid as a percentage of loan amounts to the MFI. Generally, the MFI charges 1 to 2 per cent and some times more, based on the distance of the group from the credit office and the amount of the loan. The fees and commissions are collected or deducted by MFI at the time of disbursement of loan to the SHG. Generally, these costs or expenses are called as the service charges on the loan amount.

Table 6 presents the percentage of various components of costs that is factorized in the average rate of interest charged by the SHGs (lending to its members) across average loan amount.

In determining the various factors, as a first step, the average lending rates of the SHGs are converted into the present money value and subsequently, from this total money value of interest rate the percentage of various costs are estimated. Further, by deducting all costs from the monetary value of rate of interest the percentage of margin was calculated. Table 6 reveals the percentage of average cost of funds factored in average rate of interest is relative very high as compared to any other forms of costs in SHGs. Further, the percentage of cost of fund covered in rate of interest is comparatively very high in Belthangady taluk (i.e., 70 to 75 per cent) than that in T.Narasipura taluk (46 to 51 per cent) across all quartiles³ of average loan amount disbursed. It is apparent that the SHGs in T.Narasipura taluk are generating large portion of the margin (41 to 44 per cent) through micro lending.

The percentage of total margin factored in the rate of interest is very low (8 to 15 per cent) in the SHGs of Belthangady taluk. For the small amount of loan, the average administrative costs and average other costs are very high as compared to the larger amount of loan in both the taluks. Because, the progressive lending starts with small amounts, where the administrative cost and other costs for the SHG will be higher, as the loan amount

grows it will be decreasing as a percentage to the total amount borrowed. This Table also makes clear that borrowing smaller amount of loan will be costlier to the members of microfinance groups.

The microfinance groups or SHGs work like low cost banks for the poor people in the rural areas, particularly for women. From the bank's point of view, financing to/through groups has not only reduced the transaction costs, but also improved recovery of loans substantially. In the case of an individual borrower, joint liability has reduced transaction costs on the loan by handling a group account instead of an individual account. Thus, availing the loan through the microfinance groups will uniformly allocate the costs of the loan across the borrowers based on their loan amount. In this context, the travelling cost, opportunity cost and other costs for the loan would also play a key role in determining the rate of interest in SHGs.

Opportunity cost is measured through the wage forgone by travelling to the MFIs or bank branches. Table 6 shows that the average opportunity cost is higher in SHGs of Belthangady taluk than that of T. Narasipura taluk. One of the main causes for such a difference is that the prevailing daily wage rate in Belthangady taluk is higher than that of T. Narasipura taluk and it has influenced the opportunity cost

³ The Quartiles are generated based on the frequencies of the average loan amounts (Rs.) into less than 25 per cent as first quartile, 26 to 50 per cent as second quartile, 51 to 75 per cent as the third quartile, and more than 75 per cent is the fourth quartile.

of loans. Longer the distance to the bank or field offices higher will be the opportunity cost. However, sometimes even zero travel cost could result in opportunity cost to the group. It was observed from the field that either due to

non-availability of transport or because of minimum distance (less than 5 KM), group members would walk to the bank/field office. Travel cost is comparatively higher in T. Narasipura than in Belthangady taluk. Due to scattered

Table 6: Component of various Cost in Average Interest Rate of the SHG (lending to its members) across Average Loan Amount (in Percentage)

Average Loan Amount (in Quartiles)	No. of cases (SHGs)	Average Cost of Funds (1)	Average Administrative Cost (2)	Average Travel Cost (3)	Average Opportunity Cost (4)	Average Other Cost (5)	Total cost (1+2+3+4+5) (6)	Margin Generated
------------------------------------	---------------------	---------------------------	---------------------------------	-------------------------	------------------------------	------------------------	----------------------------	------------------

Belthangady (N=53)

Less than Rs. 35000	16	69.86	11.03	1.40	1.67	7.71	91.67	8.33
Rs. 35001 to Rs.50000	18	75.48	5.68	0.68	0.84	4.33	87.01	12.99
Rs.50001 to Rs. 67000	13	72.81	6.57	0.99	1.10	4.78	86.25	13.75
More than Rs. 67001	6	75.40	4.16	0.53	0.71	3.55	84.35	15.65

T.Narasipura (N=53)

Less than Rs. 35000	11	50.63	3.63	0.63	0.47	2.68	58.04	41.96
Rs. 35001 to Rs.50000	9	46.56	6.44	1.24	0.82	2.87	57.93	42.07
Rs.50001 to Rs. 67000	13	48.71	4.51	1.03	0.59	3.08	57.92	42.08
More than Rs. 67001	20	50.73	2.56	0.44	0.34	1.76	55.83	44.17

Total (Belthangady + T.Narasipura) (N=106)

Rs. 35001 to Rs.50000	27	60.37	9.16	1.34	1.32	5.74	77.92	22.08
Rs.50001 to Rs. 67000	27	64.78	5.88	1.00	0.93	4.21	76.81	23.19
More than Rs. 67001	26	63.05	4.66	0.66	0.65	3.51	72.53	27.47
Less than Rs. 35000	26	56.42	2.93	0.46	0.43	2.17	62.41	37.59

Source: Primary Survey

distribution of bank branches and distance to the MFI credit office, travel costs are higher in T. Narasipura. For example, the microfinance members of the Vatal village of T. Narasipura taluk have to travel 15 to 20 Kms to deposit/withdraw the group's money in a bank located in the taluk headquarters. However, in Belthangady taluk, the distance to the bank or MFI branch is easily approachable.

The magnitude of other costs – hospitality to field officers, documentation - in availing the loan also plays a significant role in determining the interest

rate in SHGs. The average other cost on loan was much higher in SHGs of Belthangady taluk than in T.Narasipura taluk. Thus, it is evident that the cost of funds plays a decisive role in the determination of interest rate charged by microfinance groups. Subsequently, the average administrative cost, the average of other costs and average travel and opportunity costs will determine the rate of interest on loan in SHGs. However, the SHGs not only covered the *full cost* of loans, but also were able to generate a margin in their financial intermediations.

POLICY RECOMMENDATIONS AND CONCLUSION

The microfinance sector has two significant objectives – to reach large sections of financially excluded poor and MFIs/SHGs should cover their cost of lending through an optimal rate of interest to attain sustainability. Hence, both the goals are important for a sustainable microfinance sector. The *cost of fund* and *other costs* associated in microfinance significantly influence the rate of interest and reducing these two costs would reduce the interest rate on loans. The

competitive development of microfinance industry could reduce the fund cost to the microfinance groups. The groups need to reduce efficiently the *other costs* associated with writing and maintaining the accounts, auditing, and hospitality offered, through innovative methods of lending. In determining the rate of interest in the microfinance sector, different schools of thinkers argue differently. The supporters of the "*Sustainability Approach*" believe that higher rate of

interest is necessary to maintain the financial sustainability of the lending institution (for MFI or SHG). The followers of the "Poverty Lending Approach" argue that interest rate in microfinance is too high and it will take away all the benefits generated by the people. Hence, suitable pricing for the loan is the immediate need in microfinance sector.

Policy changes are required to address the issues of controlling the extreme rate of interest charged by the MFIs/SHGs on their loans or controlling the exploitative margin (surplus) on the loans disbursed. Hence, a cap on microfinance interest rate in India is essential for increased inclusion of the excluded.

References

- Adams, D.W. and J.D. Von Pischke (1992). Microenterprise Credit Programs: 'deja vu'. *World Development*, 20 (10): 1463-70.
- Adams, D.W., Douglas H. Graham and J.D. Von Pischke (eds.) (1984). *Understanding Rural Development with Cheap Credit*. Boulder, CO, USA: Westview Press.
- Armendariz de Aghion, Beatriz and Jonathan, Morduch (2005). *The Economics of Microfinance*. Cambridge MA: MIT Press.
- Bottomely, Anthony (1975). Interest Rate Determination in Underdeveloped Rural Areas. *American Journal of Agricultural Economics*, 57(2): 279-91.
- CGAP, (1996). Microcredit Interest Rates. *CGAP Occasional Paper*, No.1. Washington D.C. USA: The Consultative Group to Assist the Poor (CGAP).
- Christen, Robert Peck (1997). *Banking Services for the Poor: Managing for Financial Success – An Expanded and Revised Guidebook for Microfinance Institutions*. Washington D.C. USA: ACCION International.
- Harper, Malcolm (1998). *Profit for the Poor - Cases in Micro-Finance*. New Delhi: Oxford IBH and London: Intermediate Technology Publications.
- Johnson, S. and Rogaly, B. (1997). *Microfinance and Poverty Reduction*. London, UK: Action Aid, Oxfam.
- Mahajan, Vijay and Ramola, Bharti Gupta (1996). *Financial Services for the Rural Poor and Women in India: Access and Sustainability*. *Journal of International Development*, 8 (2): 211-24.
- Sa-dhan, (2004). *Operating Cost of Microfinance Services and Its Impact on Interest Rate Setting*. Discussion Paper Series, New Delhi: Sa-dhan.
- Shankar, Savita (2006). Transaction Costs in Group Micro Credit in India. *Working Paper Series*, Chennai: Institute of Financial Management and Research (IFMR).
- Shylendra, H. S. (2006), Microfinance Institutions in Andhra Pradesh: Crisis and Diagnosis, *Economic and Political Weekly*, 41 (20): 1959-63.
- Smith, Phil and Eric, Thurman (2007). *A Billion Bootstraps: Microcredit, Barefoot Banking, and the Business Solution for Ending Poverty*. New York: McGraw-Hill Publications.
- Torre, Mario La and Gianfranco, A. Vento (2006). *Microfinance*. New York: Palgrave Macmillan.
- Wright, David L. and Dewan A.H. Alamgir (2004). Microcredit Interest Rates in Bangladesh: Capping versus Competition. Retrieved from http://www.microfinancegateway.org/files/23259_David_Wright_InterestRatesPaper040326.doc, on 26.04.2006.
- Yaron, J. (1992). Assessing Development Financial Institutions: A Public Interest Analysis. *World Bank Discussion Paper* 174, Washington D.C., USA.