Chapter VI

COST OF MICROFINANCE BORROWING: BORROWERS' PERSPECTIVE

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6.1 Introduction

The last chapter, discussed about the various expenses that an MFI borne, in order to extend credit to the borrowers. The present chapter is devoted to cost of microfinance borrowing for the borrowers based on primary data collected from 571 microfinance borrowers during the field survey. From literature review it is observed that, not much is known about the cost borne by the borrowers‟ of the MFIs in the NER of India, particularly in Assam (Chapter II Section 2.9). The interest rate charged on loans is not the only cost of credit. There are other costs associated with loan while applying and obtaining credit from MFIs. These are known as transaction costs which are un-avoidable and sometimes these costs are higher than the financial cost (Rojas and Rojas 23). To evaluate the viability and efficiency of any credit program it is necessary to analyze the costs from the borrowers‟ perspective. The aim of this chapter is to analyze the cost of borrowing for the microfinance borrowers while availing credit from MFIs in Assam, India. The total borrowing cost of the microfinance borrowers includes transaction cost and financial cost.

An interview was carried out with 571 borrowers (which includes 78 JLGs and 23 SHGs) belonging to the eight selected MFIs in Assam. A structured schedule was used to collect information from borrowers.

6.2 Profile of the borrowers

The socio economic status of the borrowers of the selected MFIs in Assam is reviewed and analyzed with an aim to find out how well the microfinance borrowers‟ understand their loan contract. Loan contract includes information about loan amount, tenure of loan, repayment frequency and amount, interest rate, processing fees, security fund and insurance. Information about loan contract helps the borrowers to make informed decisions about their finances. Lack of financial awareness can lead to over indebtedness, inappropriate business decision and greater economic vulnerability for the borrowers. Hence, information on the financial awareness aspect (such as bank accounts, saving habits, awareness about their loan contracts) of the borrowers was analyzed.

It is found that most of the borrowers were able to understand their loan size, duration of loan and repayment schedule. The borrowers were also aware about the consequences of non-repayment of loan. However, only 50 percent of the borrowers were able to report the interest rate on the loan, either as a percentage or as an amount in rupees (Table 6.1).

Table 6.1: Borrower understanding about loan contract

Questions	**aware**	**Not aware**
What is the amount of loan?	97.2	2.8
What is the duration of your loan?	98.3	1.7
Knowledge about repayment schedule	100.0	0.0
Knowledge about documents required	72.5	27.5
What is the Interest rate charged on loans?	49.4	50.6
What is the applicable service tax?	37.6	62.7

Source: Field survey

Most of the borrowers did not know accurately the total expenses of the loan contract. This is due to the level illiteracy found among the borrowers. Only 15 percent of the borrowers are having access to secondary level education. The average income of the respondents is near about Rs 3000, where 49 percent of the respondents are engaged in small enterprises and 41 percent engaged in livestock farming. 62 percent of the borrowers" have individual bank account and 21 percent of the groups have group account in the bank with regular transactions of Rs 20 to Rs 50 (Table 6.2).

Table 6.2: Profile of the borrowers

Parameters	Option/category	Number of clients	Percentage
Gender	Female	571	100
Age	18-30yrs	113	19.8
	31-45yrs	398	69.7
	46 and above yrs	60	10.5
Location of the borrowers	Rural	374	65.5
	Urban	197	34.5
Source of income	Agricultural farmer	51	8.89
	Livestock farming	234	41.01
	Small business	280	49.18
	Job	5	0.9
Educational qualification	Illiterate	53	9.3
	Education upto primary level	288	50.5
	Education upto class VII	140	24.5
	Matriculate	81	14.3
	Undergraduate	7	1.3
	Above graduation	1	0.2
Monthly income of the household	Below Rs 3000	74	13
	Rs 3000-5000	38	61
	Above 5000	114	20
	Not able to answer	29	5
Individual Bank account	Yes	357	62.6
	No	212	37.3

Source: Field survey

6.3 Assessment of total cost of MFI borrowers’

For the assessment of total cost of MFI borrowers‟, activity based method[1] is adopted. This method is widely used to calculate the total borrowing cost for the poor (Swamy and Tulasimala 2009). The various activities involved while availing loan from microfinance institutions are broadly categorized into two categories, viz. Transaction cost (includes documentation cost, transportation cost, incidental cost), and financial cost. The components for transaction cost are gathered through pilot survey as these are not standardized or similar for every

[1] The activities incurring cost are identified and then cost is allocated to different activities. This helps in delineating the activities in which clients incur more cost compared to other activities.

MFI. The **Total Borrowing Cost** (TBC) is the summation of transaction cost (TC) and Financial cost (FC) i.e.

$$TBC = TC + FC$$

The cost items included in the study are discussed as follows:

***Transaction cost* (TC)** for the borrowers‟ is measured by adding the cost incurred in documentation cost, transportation and in incidental work. Opportunity cost is another important component of the TC. Documentation cost includes the cost of documents such as address proof, identity proof, proof of relationship, age proof for insurance service, certificate from village head, photographs, etc. The borrowers‟ also maintain group register to record regular savings, internal and external loans etc. In case of SHGs they have their group stamp pad, and also in some cases the group bought sitting mat to conduct the meetings. Some MFIs take stamp paper and revenue stamp from borrowers‟ before disbursement of loan. Transportation and incidentals costs are those costs incurred by the borrowers‟ while visiting the MFIs for availing loan, to the banks for enchasing cheques and also for withdrawing money and depositing group saving amount. These visits included long distance travel. In some cases, costs of light refreshment were also included.

***Financial cost* (FC)** includes insurance cost, processing or documentation cost, service tax and interest paid. Insurance, processing or documentation, service tax is fixed in proportion to the loan amount and is collected at the time of loan disbursement. Interest cost is spread over the entire tenure of the loan and calculated on a reducing basis.

The TBC is expressed as percentage of the loan amount. TC and FC are expressed as percentages of the TBC and also of the loan amount (L). Thus, (TC/TBC) x100, (FC/TBC) x 100 and (TC/L) x 100, (FC/L)x 100 are calculated. These percentages provide insight into the extent of impact TC and FC have on TBC and loan amount. The findings of this study are based on these ratios and percentages. The components included for analyses are only those which are directly related to the application, processing and maintaining credit. Detailed information and cost regarding the activities were gathered from the borrowers" and also verified from the MFI branches.

6.4 Cost components from the borrowers' perspective

6.4.1 Transaction cost

Transaction cost consisted of a) documentation cost, and b) transportation and incidental cost. Table 6.3 shows the total transaction cost incurred by borrowers" in availing the first loan. The cost of documentation included the cost of register, stamp pad, stationary, group photograph, and individual photograph, and revenue stamp, certificate from village head, address proof and identity proof. Transportation cost included the cost of traveling to the MFI and bank for availing loan. In addition to this, the group incurred cost in buying sitting mat for conducting meetings, and other incidental cost and opportunity cost.

Table 6.3: Transaction cost in availing first loan

	Mean	Std. Deviation	Minimum (in Rs)	Maximum (in Rs)
A. Initial cost (for individual respondent)				
Cost of Register (Record books maintained by the groups)	7.94	8.55	1.00	24.00
Cost of stamp pad	1.49	3.57	0.00	10.00
Cost of stationary	1.27	0.45	1.00	2.00
Cost of sitting mat	4.53	6.56	0.00	17.00
B. Cost of documentation (for individual respondent)				
Cost of group photograph	0.30	0.71	0.00	2.00
Certificate from village head	14.73	8.20	0.00	20.00
Cost of stamp paper	0.72	1.28	0.00	4.00
Cost of revenue stamp	0.46	0.50	0.00	1.00
Cost of joint or individual photographs	32.43	11.10	20.00	50.00

	Mean	Std. Deviation	Minimum (in Rs)	Maximum (in Rs)
Cost of duplication of address proof, PAN card	2.16	1.78	1.00	8.00
C. Transportation and incidental cost				
Transportation cost	18.85	20.83	0.00	60.00
Incidental cost	0.74	1.88	0.00	10.00
Total cost (A+B+C)	**85.63**	**35.12**	**30.00**	**142.00**

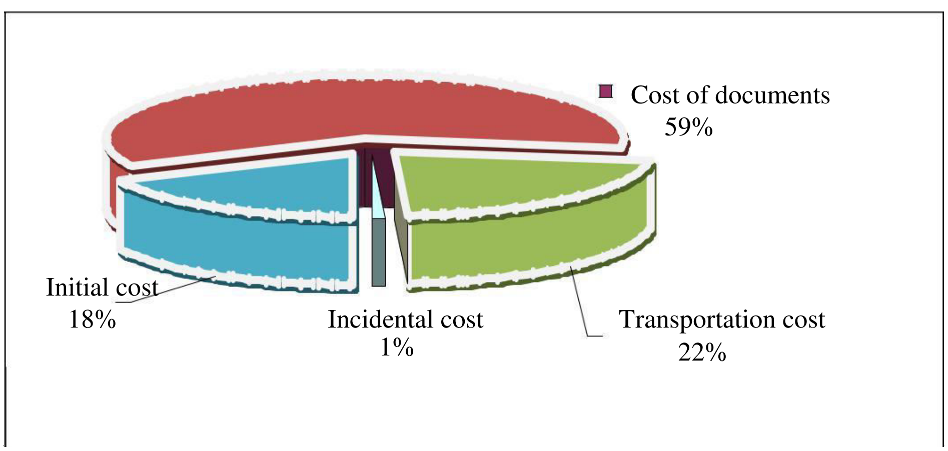
Note: In some cases the cost is “0” as no cost was associated with the activity
The figure represents the average cost of an individual client.
Source: Author‟s Calculation.

The initial cost in case of first loan included the cost of register, stationary and sitting mat. The major part of initial cost included the cost of register, which was required to maintain group attendance record, minutes of the meetings and record of internal loans. In case of SHGs, it was observed that they maintained three separate registers for each activity, which increased their initial cost. In addition, the SHGs have their own stampad, which incurs a cost of Rs 10 per member. Whereas, the JLGs maintained only one register to record their attendance and meeting minutes. Hence, the initial cost was higher for the SHGs as compared to other lending models. In case of SHGs the initial cost for an individual member varied from Rs 17 to Rs 24. Another major part of initial cost was incurred by the groups in buying sitting mat for group meetings.

The documentation cost varied substantially from one MFI to another. One of the reasons of such heterogeneity in documentation cost appeared to be the fact that different MFIs required different documents for loan sanction and maintenance. For instance, all the NBFCs collected only two joint photographs, address or identity proof from borrowers, whereas some NGO-MFIs collected only photographs from the borrowers. It was observed that in rural areas the cost of identity proof was higher as compared to urban areas. This was because villagers were required to obtain identity certificate from the village head, which cost between Rs 10 to Rs 50, whereas in urban areas, the borrowers usually had PAN card or other identity proof.

The documentation cost also varied with lending models followed by the MFIs. Under SHG model, the members had to submit their documents both to the bank and to the MFI. The documentation costs involved in this process was therefore higher than JLG model. The transportation cost included the cost of traveling to the MFI and bank for availing loan. The transportation cost mainly depended upon the distance of the MFI from the borrowers residence. Significant positive correlation (0.605) was observed between the distance of the MFI and the cost of transportation. The cost also depended on the number of members in the group. Further, it was observed that in case of SHGs incidental costs did not exceed Rs 10/-. The proportion of initial cost, cost of documents, transportation cost and incidental cost in total transaction cost of the client is reported in Figure 6.1. A significant portion of transaction cost was in documentation (59 percent) and transportation cost (22 percent).

Figure 6.1: Proportion of each activity in total transaction cost of the borrowers'



Source: Author"s Calculation.

6.4.2 Financial Cost: Financial costs were unavoidable and the borrower had to bear the costs to avail the loan. For instance, the borrower had to pay processing fees, service tax and insurance in order to avail loan. The interest cost was spread over the full tenure of the loan. Table 6.4 reports the mean and standard deviation values for each category of financial cost and the total cost incurred (financial cost plus transaction cost) by the borrower based on the mean loan size is reported. The descriptive statistics (mean and standard deviation) for the loan amount, financial cost, transaction cost and total borrowing cost is calculated.

All the MFIs are collecting processing fees and service tax as per RBI guidelines (RBI, 2011). Two MFIs are not extending insurance service to their borrowers. Other MFIs charged a fixed insurance premium from borrowers‟ based on their loan slab. While insurance premium was an extra burden on the poor borrowers, it provided security against unforeseen events to both the MFI and the borrower.

Table 6.4: Total borrowing cost for individual borrowers

	Mean (in Rs)	**Std. Deviation**
A. Loan amount	13147.73	5816.90
B. Processing fees	126.05	63.98
C. Service tax	11.69	9.92
D. Insurance	92.02	77.50
E. Interest paid	2083.64	1288.66
F. Total financial cost (B+C+D+E)	2313.41	1371.44
G. Transaction cost	85.63	35.12
H. Total Borrowing cost (F+G)	2399.55	1367.99

Source: Author‟s Calculation

The MFIs were charging interest rate on a reducing balance. The interest rate ranged from 18 percent to 26 percent. It was observed that in the given data the average loan size was Rs 13147.73/- and the resultant mean financial cost equalled to Rs 2313.41/ (which includes processing fees, service tax, insurance charge and interest paid for loan). Hence, the average financial cost was 17.59 percent of the average loan amount.

The next section highlights the MFI wise total cost of borrowing against two loan sizes i.e. Rs 10,000 and Rs 15,000, which were common among all the MFIs. Table 6.5 presents the various charges, transaction cost and borrowing cost for these two loan sizes. All the MFIs (except one) were charging one percent processing fees and service tax at 12.36 percent of processing fees. The insurance charges varied from Rs 47 to Rs 78, as it depended on the insurance company the MFI was associated with. It was observed that for a loan size of Rs 10,000 the total borrowing cost varied from Rs 1,394 to Rs 2,760. The transaction cost for all the MFIs varied from Rs 40 to Rs 60. Huge variation in total financial cost of the borrowers was observed. This was due to different interest rates and insurance charges imposed by the MFIs on the borrowers. For instance, the total borrowing cost of Prochesta, an NGO-MFI was less than that of other MFIs. The borrowing cost was highest for RGVN (North East) Microfinance Private limited which charged 26 percent interest on loan amount. In contrast, Prochesta charged interest rate at 22 percent only.

Similarly, for the loan amount Rs 15,000 the total borrowing cost is reported.

Table 6.5: Total cost of borrowing for loan size of Rs 10,000 and Rs 15,000

Loan Amount	Loan Features	RGVN (NE) MFL	AFPL	UFSPL	Prochesta	MZGPS	NCS	ASC	SATRA
Rs 10,000	Processing fees (in Rs)	100	100	100	100	0	Not available	100	100
	Service tax (in Rs)	12.36	12.36	12.36	12.36	0		0	0
	Insurance (in Rs)	78	0	47	60	0		100	102
	Installment amount (in Rs)	220	230	215	93	530		202	375
	Repayment period (in weeks)	52	50	52	12*	24*		50	31
	Total amount paid (in Rs)	11359	11350	11215	11160	12720		11000	11525
	Interest paid (in Rs)	1359	1350	1215	1160	2720		1000	1525
	Total financial cost (in Rs)	1549.36	1462.36	1374	1332.36	2720		1200	1727
	Transaction cost (in Rs)	60	40	54	62	40		60	85
	Total Borrowing cost (in Rs)	**1609.36**	**1502.36**	**1428**	**1394.36**	**2760**		**1260**	**1812**

Loan Amount	Loan Features	RGVN (NE) MFL	AFPL	UFSPL	Prochesta	MZGPS	NCS	ASC	SATRA
Rs 15,000	Processing fees (in Rs)	150	150	Not available	Not available	Not available	150	150	Not available
	Service tax (in Rs)	18.54.00	18.54.00				0	0	
	Insurance (in Rs)	114	0				250	150	
	Installment amount (in Rs)	350	345				1009	339	
	Total amount paid (in Rs)	17053	17025				18159	50	
	Interest paid (in Rs)	2053	2025				3159	2250	
	Total financial cost (in Rs)	2335.54	2193.54				3559	1950	
	Transaction cost (in Rs)	142	79				35	70	
	Total Borrowing cost (in Rs)	**2477.54**	**2272.54**				**3594**	**2320**	

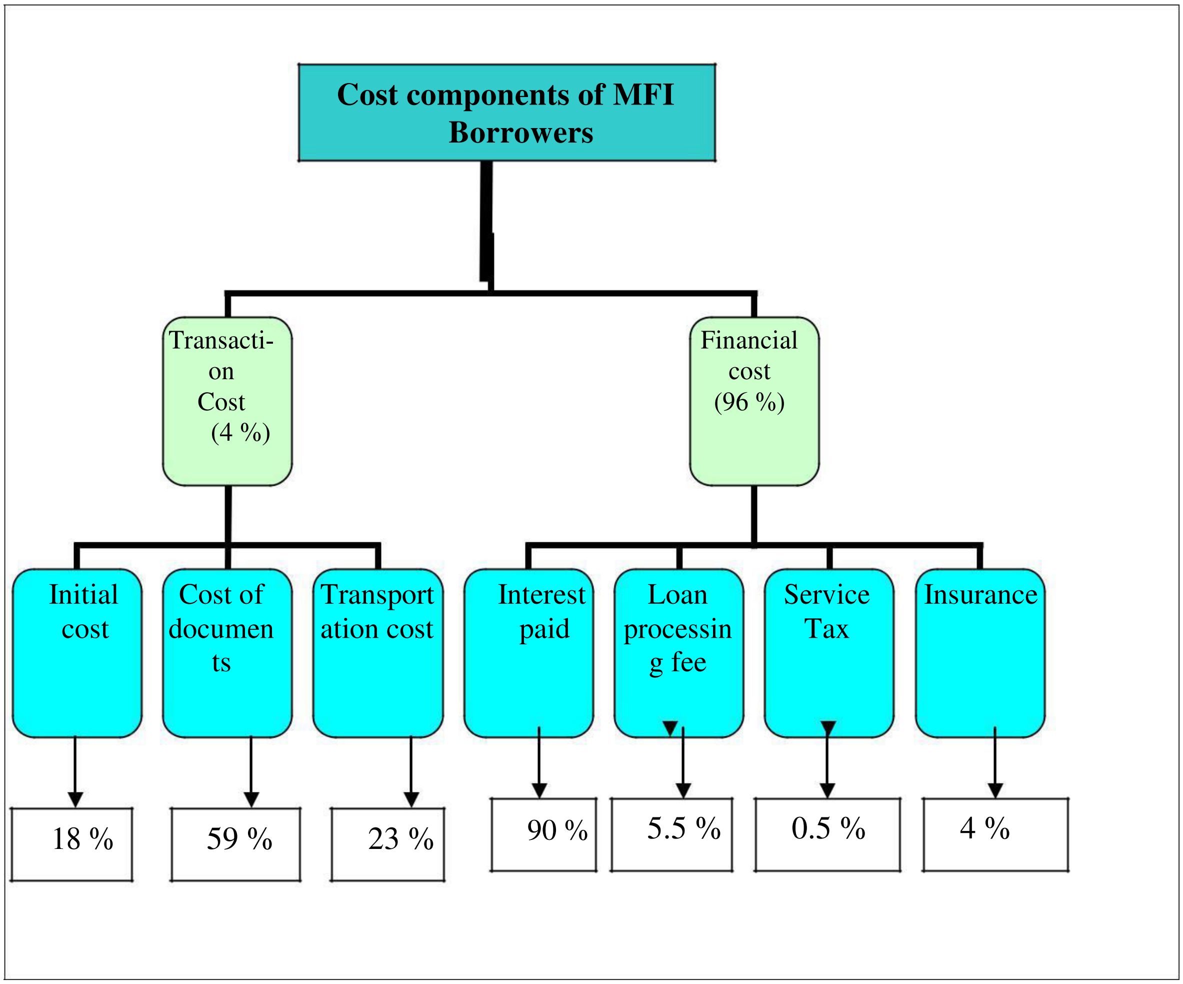
Note: For * Monthly repayment schedule

Source: Field survey

6.5 Findings

1. The borrowers incurred 96 percent financial cost and only four percent transaction cost, while availing loan from the MFI (Figure 6.2). Cost of documentation in transaction cost and interest rate on financial cost appears to be the major contributor of borrowers cost.

Figure 6.2: Total borrowing cost of the MFI borrowers



Source: Author"s compilation
Note: * Average of loan amount of the MFI borrowers

2. Transaction cost in subsequent loan cycles

Table 6.4 shows the average, standard deviation, maximum and minimum of various non recurring components of transaction cost for borrowers of MFIs in Assam. It was observed that the average non recurring transaction cost in subsequent loan cycles reduced by 21.6 percent in comparison to the cost of availing loan in first cycle. In general, the transaction cost for the borrowers in the subsequent loan cycle was lower than the cost in the first loan cycle (Shankar 1337). This is because some of the costs, especially initial costs, were one time costs and non-recurring in nature.

Table 6.4: Transaction cost for borrowers in subsequent year (for individual respondents)

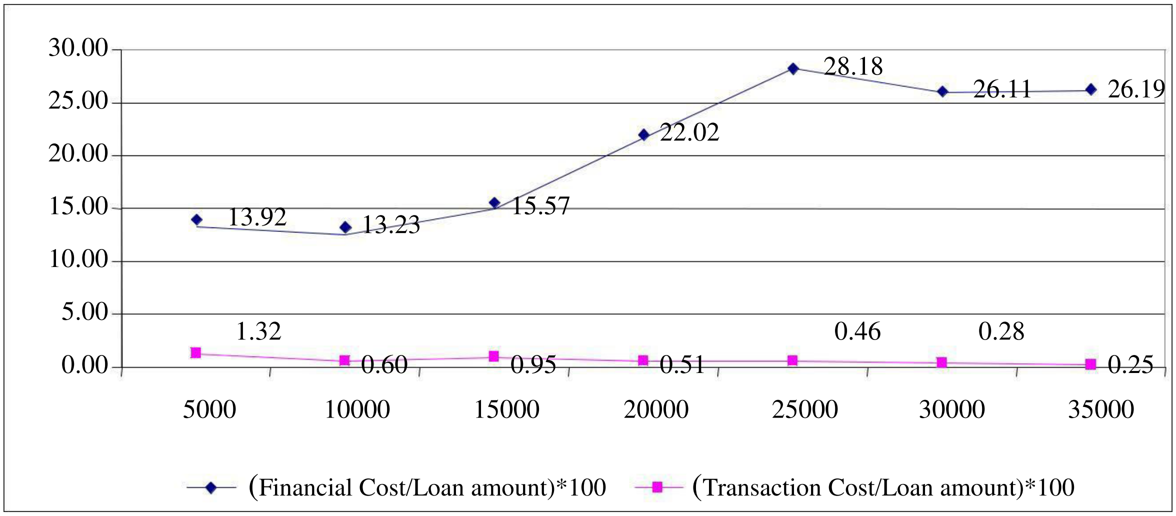
Parameters	Mean (in Rs)
A. Initial cost	15.23
B. Cost of documentation	50.8
C. Transportation and incidental cost	19.59
D. Total Transaction cost for first loan cycle	85.62
E. Transaction cost in subsequent cycle (Total Transaction cost -Initial cost)	70.39

Source: Author‟s Calculation.

3. *Relation of transaction cost and financial cost with loan amount*

   The total borrowing cost for various loan slabs were also calculated. It was observed that the total borrowing cost decreased with the increase in loan amount. The total borrowing cost was further divided into financial cost and transaction cost. The financial cost varied between 14 to 27 percent of the loan amount. Moreover, the cost was low compared to the cost incurred in direct lending from banks (Swamy and Tulasimala 69). They also reported that the transaction cost incurred under direct lending from banks was 9.2 percent of the loan amount (Rs10,000), whereas this study indicated that the transaction cost for Rs10,000 was only 0.6 percent of the loan amount. Figure 6.3 represents the trend of the ratio of financial cost to loan amount and ratio of transaction cost to loan amount. The financial cost increased with the increase in loan amount. However, the transaction cost tended to decline with the increase in the amount of credit; for amounts greater than Rs10,000 they represented less than 1 percent of the credit amount. Thus credit was more expensive for small amounts of loan (Rojas and Rojas 34). Thus, for credit of Rs 5000 the proportion of transaction cost was 1.32 percent of the loan amount, whereas for credit of Rs 20,000, the transaction cost was only 0.50 percent of the loan amount. This went down further to less than one percent for credit of Rs 5,000.

Figure 6.3: Relation of transaction cost and financial cost of in respect to loan amount



Source: Author‟s calculation

4. From the present study it was observed that the total transaction cost for was much lower, varying from Rs 54 to Rs 142, than that indicated in earlier studies such as Karduck and Seibel, (2004) or Swamy and Tulasimala, (67), who reported transaction cost between Rs 169 to Rs 870. Transportation cost also reduced to a large extent as members visited the branch only at the time of loan disbursement**.**

   It was found that RGVN (NE) MFL disbursed loan cheques at the client‟s doorstep, which reduced the cost of transportation and also gave flexibility to members to encash the cheque at their own convenience.

5. For the MFI borrowers in Assam, opportunity cost appeared to be negligible. This seemed to be a unique feature of MFIs in Assam, as the opportunity cost was usually considered an important component of the cost structure. For instance, Swamy and Tulasimala (67) reported opportunity cost of Rs 60 per day for borrowers‟ and Hossieni et al. (249) reported that borrowers‟ incurred more than 30 percent of the total cost as opportunity cost. However, in this study it was found that MFIs arranged the meeting schedules in such a way that members incurred minimum or no loss of income in attending meetings.

6.7 Conclusion

The empirical results highlight the importance of transaction cost and financial cost in the total borrowing cost of the borrower. The total borrowing cost for various loan slabs was also calculated. It was observed that the total borrowing cost decreased with the increase in loan amount. The proportion of total borrowing cost varied between 14 to 27 percent of the loan amount. Moreover, the cost was lower than the cost incurred in direct lending from banks. The total cost was divided into financial cost and transaction cost. Financial cost was imposed by the MFIs and was similar for all borrowers availing loan from the MFI, whereas transaction cost varied with age, educational qualification and monthly income of the borrower. Transaction cost accounted for only three percent of the total borrowing cost. Transportation cost and documentation cost had stronger influence on the transaction cost of the borrower. These two items comprised 81 percent of the total transaction cost incurred in availing credit from the MFIs. This indicated that MFIs in future may concentrate on these two components of transaction cost to reduce the cost of credit for borrowers. It was observed that the average transaction cost varied significantly across different lending models and also with loan size. The analysis results imply that there was an inverse relationship between the cost of credit and amount of credit. The study also showed that some MFIs imposed higher documentation cost than others. From a transportation cost perspective, MFIs within a distance of two km from the borrower‟s place were more cost effective for the borrower. Hence, the distance from the borrower‟s household to the lending institution exerted a positive significant effect on the transaction cost. This in turn emphasizes the importance of expansion of MFI branches and extension activities in lowering the transaction cost for borrowers.

In contrast, to other studies, this study showed no significant influence of the opportunity cost on the total borrowing cost. Another important observation was that all the MFIs disclosed and communicated their interest rate, processing fees, service tax and insurance fees to the borrowers. The interest rate did vary with the size of the loan. This ensured long term survival, growth, and effectiveness of MFIs operating in the state. A positive relationship between the interest rate and the total financial cost for the borrower was also observed**.** It was found that the insurance products offered by the MFIs provided a cushion to the MFIs in case of death of the borrower or the guardian. There was a need to modify the products according to the requirement of the borrowers.

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