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Transaction Cost of Lending in Rural Finance

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Contents

1 Introduction	2
2 Evaluation of transaction cost in Micro finance	6
3 Annexures	15
3.1 Annexure 1: Processes for First Loan to a Group	15

1 Introduction

Agriculture sector is a key component of the Indian Economy. Even though the contribution of Agriculture in overall GDP of the country has declined¹ from 44.5 per cent in 1970-71 to around 20.0 percent in 2005-06,² agriculture continues to be the principal source of livelihoods for around 62.0% of the country's population.³ In the last decade while the Indian economy has done quite well overall,⁴ achieving a Compounded Annual Growth Rate (CAGR) of over 6.0%, agriculture has remained sluggish with a CAGR of only 2.0 %. Given the strong backward and forward linkages of agriculture with the overall Indian economy and its sheer scale, a strong growth in agriculture (at the rate of 4.0-5.0% per annum) has the potential to catapult the Indian economy to well past 10.0% growth trajectory.⁵ A stronger growth in agriculture would lead to higher income for farmers, generate more employment opportunities and sharply reduce poverty. It is our belief that for India, a rapid growth in the rural economy overall, and within that of agriculture, is highly feasible⁶ and may hold the key to addressing India's problems of growth and

¹During the 54 years of Planning between 1950-51 and 2004-05, the share of agriculture in GDP has fallen by more than half from 59 per cent to 24 per cent, whereas the share of industry has almost doubled from 13 per cent to 25 per cent and the share of services has increased from 28 per cent to 51 per cent. The steep fall in the share of agriculture in GDP is due to the fact that its growth rate at 2.7 per cent per annum has been less than half of the growth rates of 5.6 per cent per annum for industry and 5.7 per cent per annum for services. Refer <http://www.organiser.org/dynamic/>

²Economic Survey 2004-05

³For more details refer economy overview in www.economywatch.com

⁴India is the fourth largest economy as measured by purchasing power parity (PPP), with a GDP of US \$3.36 trillion. When measured in USD exchange-rate terms, it is the tenth largest in the world, with a GDP of US \$691.87 billion (2004). India was the second fastest growing major economy in the world, with a GDP growth rate of 8.1% at the end of the first quarter of 2005-2006. For more details refer http://en.wikipedia.org/wiki/Economy_of_India

⁵"In two to three years, India should be targeting 10% growth if its savings rate improves, agricultural output increases, and infrastructure is substantially upgraded", Prime Minister Shri Man Mohan Singh at the India Economic Summit (November, 2005). It may be noted that 1% growth in agriculture would translate to only 0.2% growth in overall economy as agriculture' share in overall economy is around 20%. In real senses even if agriculture grows at the rate of 4-5% from current level of less than 3% the impact on economy will not be more than additional 0.4-0.5% in overall economy growth. Therefore growth in agriculture has to be complemented with growth in infrastructure facilities, growth in savings rate besides higher growth in services and industries segment. However even a 1% additional growth in agriculture is desirable as it directly impacts the employment and poverty levels in the countryside. The spread effects of doubling of agricultural growth are greater due to the multiplier effect of agriculture in the overall economy. It has been estimated that one incremental percentage growth in agriculture leads to an additional income generation of Rs. 100.00 bn in the hands of the farmers thereby increasing their disposable income and ultimately, their purchasing power.

⁶On the one hand, India's position as a production base for most "dry" commodities such as wheat, rice and maize maybe unattractive because of small farm holdings, high volatility in rainfall patterns, low levels of mechanisation and the high levels of subsidies offered by international producing nations to their own farmers. Conversely, it is possible that horticulture in India could yield handsome returns. In fact, while overall growth of agricultural production has languished at below 2 %, horticulture already increased its contribution to 28 % of AGRI GDP and 54 % of the export share of agriculture, all from a cultivated area share of 8.5 % only. Traditionally, it has suffered primarily due to a lack of customer focus, outdated varieties and huge wastage of 25 - 30 % of output due to a poor supply chain of pre-cooling units, cold storage, and refrigerated transport. However, this could be poised for a dramatic change. The growing popularity of tropical fruits, Organic farming and semi-processed (cleaned, pre-packed and pre-cut) fruits and vegetables could work in India's favour as they enable us to take advantage of a high labour component to become a competitive force. The willingness of the international customer to pay a premium for these offerings make investments in the required certification, irrigation and other infrastructure necessary for the development of both the fresh, as well as processed, fruits

poverty eradication - unlike in the rest of the region where urbanisation and growth in manufacturing have been the principal drivers.⁷

It is our belief that in order to deliver on the promise of agriculture and to set it firmly on a longer term growth path, it is necessary that a self sustaining low cost delivery system is developed establishing linkages within different players for sharing technology and data.

The high transaction cost coupled with cost of delivery and risk loss provisions is major constraint for banks and other lending institutions including Micro Credit Institutions. The small size of seasonal agricultural credit, wide geographical spread, poor transport and communication infrastructure results in higher transaction costs for rural banking. The regulated interest rate for agriculture lending further erodes the capacity of banks in particular to service their portfolios.

The cost could broadly be segregated in four categories.

- Cost of funds raised either as deposit or borrowing
- Transaction cost
- Risk loss provisioning

The cost of establishment of branch is absorbed over the period of time and depends upon individual choice of the lending entity. While commercial banks can bring down establishment cost significantly by partnering with local Micro finance Institutions, the availability of such partners is limited and most of MFI are clustered in South India. The establishment cost also includes proportional allocated cost of monitoring offices such as regional office and head office.

The cost of raising funds by way of deposits and borrowings depend on reputation and reach of the institution. The share of Interest paid on deposit / borrowings and other Interest expenses by Scheduled Commercial Banks slipped from 66.8% in 2003-04 to 64.2% in 2004-05. During same period share of establishment expenses increased from 20.0% to 20.9% and other expenses increased from 13.2% to 14.9%.⁸

The transaction cost further consists of cost of undertaking transaction in both centralised and decentralised mode and includes cost of delivery of funds to the borrower

and vegetable sector well worthwhile. For example, expensive oils such as Menthol and Patchouli have very manual processing requirements, which once again provide a source of competitive advantage to India. Also refer to Singh (2005).

⁷Jones (2006).

⁸For more details refer Statistical tables relation to Banks in India in <http://www.rbi.gov.in>

through touch point. The type of transactions a bank or financial service provider undertakes in rural lending consists of selected product delivery like accepting deposit, opening of savings account, disbursing a loan / overdraft / cash credit facility and ancillary services like remittances and collections of funds / negotiable instruments.

The ability of an entity to absorb transaction cost depends upon the size of the transaction and in rural environment, the small value lending dents the earning of the lending entities as cost of activities like selection of borrower, processing of applications, document handling, monitoring accounts does not change with amount of transaction. The reduction in transaction cost could be a major trigger for lowering of cost of delivery of credit and ultimate cost of funds to the borrower.

The transaction cost consists of interaction with farmer (typically involving stages such as, application, sanction, disbursement and weekly or monthly collection). It further includes service (comprising of sales / credit / sanction/ collection), stationery/documentation, stamp duty and other ancillary costs etc thus translating to a transaction cost of about 20.0% or higher on an loan size of about Rs 10,000.⁹ If we account for an additional 2% of average risk charge for farmer loans, and a component of cost of funds of 10% for the bank, then even with a minimum spread the lending rate would need to be around 32% per annum. In our view, the imposition of interest rate cap has directly been responsible for the high degree of exclusion¹⁰ that is observed because such interest rates make it viable to serve only the larger and richer borrowers.¹¹ While continuing efforts to research the drivers of these costs need to go on, the whole interest rate paradigm would need to be examined carefully to allow full recovery of the attendant risk charges and transaction costs.¹²

¹³For Micro Credit institution, the cost involved includes direct and indirect transac-

⁹However such costs up to a certain level can be brought down in percentage terms to about 3%- 4% for non-marginal farmers, when the average loan size increases to Rs 15,000 to Rs 25,000.

¹⁰Basu (2006) writes that interest ceilings tend to reduce the supply of credit to the poorer section of society as formal lending gets concentrated towards less riskier or bigger farmers. Interest caps have also led to lack of transparency in the formal rural lending as in some cases various service charges, application fees are charged making the true cost of borrowing to be high than the stipulated rates. Priya argues that a far more effective way for government to ensure low interest rates for poor is by fostering healthy competition within the financial sector. Akula (2006) also point towards a similar fact by stating that in countries like Columbia and Tunisia where interest caps are imposed the poor have actually received only a quarter of finance than did he poor in countries like Bolivia and Morocco with no interest caps.

¹¹Also refer Sinha (2000) for how interest rate caps have led to the exclusion of poor by lending agencies.

¹²Prahalad and Hammonds (2002) argue that the issue is not just cost, but also quality—the quality of water, the range and fairness of financial services, the variety and quality of food. The current informal system that serves poor communities is not only unorganized but also full of inefficiencies and intermediaries or middlemen who exploit those inefficiencies. Creating real markets among the poor—with adequate information, competition, and choice—can change the situation. Allowing the benefits of organization, logistics, information technology, and scale to bear upon the problem can lead to a “win-win” solution. If we can remove the inefficiencies of the unorganized sector, we will find an attractive market—for consumers and for firms.

¹³Shankar (2006)

tion cost. While the direct cost consists of expenses incurred on Group formation, training the group members, appraisal of borrowers, documentation and disbursement charges, loan monitoring, and collection etc. the indirect cost consists of proportionate allocated cost of branch, division and head office expenses. The level of expenses also changes with vintage of MFI as in case of mature MFI, the borrowers approach themselves with prior knowledge of procedural requirement due to mouth publicity.

The study of transaction cost structure through a bank branch and MFI has revealed following results.

2 Evaluation of transaction cost in Micro finance

Comparison across models

	Cost per loan		Cost % of loan		Cost % of loan	
	MFI	Commercial Bank	MFI	Commercial Bank	MFI	Commercial Bank
Average loan size			10000	10000	25000	25000
No. of members per group	5	5				
Cost components						
A. Direct Transaction Cost						
Group formation-Cost per loan (Interview and observation based)	92	91	0.9%	0.9%	0.4%	0.4%
Training	56	118	0.6%	1.2%	0.2%	0.5%
Appraisal cost	12	25	0.1%	0.3%	0.0%	0.1%
Documentation	8	11	0.1%	0.1%	0.0%	0.0%
Disbursement	3	6	0.0%	0.1%	0.0%	0.0%
Administrative time	74	156	0.7%	1.6%	0.3%	0.6%
Branch Manager Supervision	39	214	0.4%	2.1%	0.2%	0.9%
Loan utilization Check	8	17	0.1%	0.2%	0.0%	0.1%
Monitoring	166	195	1.7%	2.0%	0.7%	0.8%
Branch office supervision		1126	1.1%	11.3%	0.5%	4.5%
Account opening cost		24		0.2%		0.1%
Cash handling cost		78		0.8%		0.3%
Total Direct Transaction Cost	572	2062	5.7%	20.6%	2.3%	8.2%
B. Indirect Transaction Cost						
Allocated Divisional Office and Head Office Expenses	302	94	3.0%	0.9%	1.2%	0.4%
Total Indirect Cost	302	94	3.0%	0.9%	1.2%	0.4%
Grand Total of Transaction Cost	874	2156	8.7%	21.6%	3.5%	8.6%

Notes: Timing of the various activities viz Group formation, training, documentation etc. from the study¹⁴ conducted by IFMR. Though for the percentage calculation of transaction cost, the following criteria have been used: average loan size of 10,000/- and 25,000/-, our RMBG experience the average loan size is Rs.5, 600 for

¹⁴Shankar (2006). The results of the study on transaction cost of two MFI's are in Annexure 1.

Commercial Bank Portfolio and Rs.3427 for MFI. For this loan size the percentage are given below.

	Loan Size	
	5,000	3,427
	Commercial Bank	MFI
MFI Model	15.6%	25.5%
Commercial Bank	38.6%	63.1%

Further if we add cost of funds and risk loss provisioning, we may have somewhat below cost structure.

Nature of cost	Commercial Bank	MFI	Commercial Bank	MFI
	Loan size Rs.10000	Loan size Rs.10000	Loan size Rs.25000	Loan size Rs.25000
Cost of funds	9.50%	10.00%	9.50%	10.00%
Transaction cost	21.6%	8.7%	8.6%	3.5%
Loss provisioning	2.00%	4.00%	2.00%	4.00%
Total Cost	33.1%	22.7%	20.1%	17.5%

For the borrower the cost would add following factors.

Insurance - Hospitalisation could be covered at Rs.100/- per individual or Rs.500/- for family for sum insured of Rs.5000/- per individual or Rs.15000/- per family per year. For critical illness, premium could range between Rs.50/- to Rs.300/- for fixed payout in the range of Rs.3000/- to Rs.20000/-.

Stamp duty - 1% for small loan and approx. 0.5% in case of loan beyond Rs.50000/-

While Micro Credit institutions and banks are major formal financial service providers in rural India, due to historical reasons and imperfect lending methods, the commercial banks and cooperatives including cooperative banks are carrying higher burden of risk provisioning. This could be gauged from overdue to total demand ratio of 15.27% for State Cooperative Banks, 32.86% for District Central Cooperative banks and 33.59% for Primary Agricultural Societies as on March 2005.¹⁵

We feel that addressing the issue of risk provisioning by sharing of data base, hybrid models bringing partnership between MFI and Commercial banks /Cooperatives and Commercial banks coupled with introduction of innovative technology could bring a sea change in cost structure of agricultural lending.

A change in delivery mechanism coupled with sharing of technology driven resources platform, enhancing freedom on determining interest rates to financial service providers, usage of customer friendly insurance schemes and intervention of Government by lending

¹⁵Refer www.nafscob.com

financial support in case of natural calamities could trigger rapid growth of agricultural lending at market driven rates.

We feel that transaction cost could be kept low by adopting technology-based platform.

1. Automation

One of the important reasons¹⁶ for the failure of many providers of rural finance has been their inability to properly manage their operations in a cost effective manner. Automation through the creation of a Banking Platform that offers its services to co-operative banks, regional rural banks and scheduled commercial banks on an Application Services Provider (ASP) basis would be cost effective and will be well managed by professionals. While a few Rural Financial Institutions (RFIs) in India have grown to scale but individually, none of the RFIs have resources to invest in development of unique software or systems for their exclusive use, as this would involve high upfront costs, even if it were to scale its operations extensively.¹⁷ In the meanwhile, the lack of efficient systems acts as a deterrent to growth. Therefore, creation of a sectoral IT resource for RFIs presents itself as the most workable solution. Such a sectoral resource could be shared across RFIs, thereby improving their capacity to scale up in terms of reach and range. The common solution would provide RFIs with a ready platform to achieve reasonable size and scale without incurring heavy capital expenditure.

There are a number of examples of banking systems adopting this approach so that a low cost and relatively rapid migration to high quality banking systems can take place.¹⁸ FINO has been built as a platform to provide exactly these services

¹⁶Mor et al (2006)

¹⁷An indicative quote for a single medium scale deployment is put at Rs. 95.0 million. This covers the cost of the hardware platform, network connectivity, setting up of the data centre, facilities management and managed IT services that come up to Rs. 65.0 million. The cost of the solution license, customisation and integration is estimated at Rs. 30.0 mn.

¹⁸Firpo (2006) suggests that reaching out to the poor requires use of innovative technology. However, creating separate solution for each institution is neither sustainable nor scalable. She argues that shared infrastructures and common standards can significantly lower the costs of providing financial assistance to the rural populace. Such sharing is required to increase the number, and reduce the costs of access, points through which client can obtain financial services. Even in the urban context, Business models have changed to allow cooperation and competition to co-exist as financial actors are building shared infrastructures to reach a growing customer base. For example, initially, banks issued their own credit cards for use within exclusive merchant agent networks. This exclusive strategy, however, dampened any chance to get scale as it was proving unsustainable for the issuing banks. Bank of America finally broke this logjam when under the leader leadership of D ship Dee Hock, it developed the VISA model – a shared network owned now by more than 20,000 000 member banks from around the world. Within the VISA model, member banks agreed to establish a common architecture with standards adhered to by all members that would permit shared technologies to be developed that could settle financial transactions among a large number of merchants and banks. In the US, banks share the costs of the infrastructure elements, including technology investments that are too expensive for any single player, yet they continue to compete on differentiated services. The breaking of walls between the banks in turn has permitted shared technologies to be built that could enable scaling up of the industry while also improving the services

to Rural Financial Institutions (RFIs) and is currently in the process of being rolled out to three different types of RFIs including a co-operative bank, one scheduled commercial bank's rural operations and a non-bank finance company operating as a lender in rural India. The automation effort being undertaken by FINO combines the benefits of the card platform developed earlier in the form of a multi-account debit card and a number of new and existing Point-of-Sale (POS) terminals to ensure that card-holders are able to access a full suite of high quality financial services even from very small RFIs.

Similarly, village based transaction point for servicing the financial needs of the poor could be created.¹⁹ However, if this channel is set up primarily to deliver the financial services, the costs of serving the clients will be prohibitive. There is a need for a shared services network that can recover the servicing costs over multiple applications. Internet based kiosks can be one such transaction point. Such a channel can provide e-governance applications, agriculture extension services, Internet²⁰ connectivity, telemedicine and health diagnostics lab, crop diagnostics, education and entertainment, recruitment/employment center and financial services like life and health insurance. Through these one-stop shops consumers in even remote parts of the country can participate in the mainstream economic activity at low costs.

2. Investments in POS and Digital Money Infrastructure and Fiscal Incentives for Movement away from Cash and Cheque on a System Wide Basis

Research by McKinsey²¹ suggests that it is not the number of people or the number of branches that are the drivers of high costs in a financial system. Movement away from cash towards digital money holds the key to sharply lowering the transactions costs associated with rural finance and also allows the improvement of information management. The current fiscal structure seeks to tax the use of cards thus making it more desirable to stay with cash as the principal means of exchanging value. If, instead, as in the case of South Korea strong incentives were provided on all transactions that take place without the use of cash, the savings on transactions costs would be quite large. ²²FINO (Financial Innovations and Network Operations)

delivered to a rapidly growing customer base.

¹⁹Mor and Ruchismita (2006)

²⁰ITC's e-Choupal is a good example of how they can serve as procurement and purchase points and facilitate price discover mechanisms for the farmers, eliminating the need for middlemen. The ITC hub has now also become a distribution channel for its consumer goods division.

²¹Bekier and Nickless (1998)

²²Mor et al (2006)

has developed the capability to issue Biometric Debit Cards and Smart Cards but would need a national infrastructure of Point of Sale (POS) Terminals at various sales locations that can read these cards and transmit the information to FINO's central database. While FINO is attempting to develop commercially self-financing ways of putting these POS Terminals in place, if a consortium of banks, supported in part by a one-time subsidy from the Government, can allow FINO to roll these POS terminals out faster, it would allow a reduction in transactions costs and better information management that much sooner, directly resulting in a reduction in interest rates.

The financial cost depends upon the source of the funds the lending institution can acquire. The Scheduled Commercial Banks enjoy advantage on Micro Credit Institutions in this regard. However lack of proximity to borrower and higher transaction cost wipes off the advantage of cost of funds.

3. Decontrolling Interest rates on Agricultural lending

The regulated Interest rates on lending for agricultural activities have resulted in distribution of subsidized finance to borrowers irrespective of security / credit history/ viability of activity financed. It results in financial service providers not giving preferential interest rates to borrowers with better credit history. The removal of capping on interest rates would help banks offer affordable rates to borrowers with good credit history and at the same time keep higher margins for borrowers with no prior credit history or for unsecured lending since these could require higher loss provisioning.

A major part of cost of agricultural lending comes from provisioning for and writing off of the loss assets. The building up of the rural infrastructure could have beneficial impact on recovery and disposal mechanism of assets, which in turn could reduce the cost of recovery and give impetus to recovery mechanism. This would lead to decline in risk provisioning requirement in short term.

4. Better Market Risk Management

Market risks are a result²³ of both variations in supply and demand for crops that are not subjected to binding price controls and from the inability of controlled markets to respond timely and efficiently to changes in the market conditions. Variation in the market price fetched by the farmers is a reflection of the market risk. Market

²³Hollinger (2004)

risks may be due to factors affecting timely delivery of produce to markets or the quality of the produce (e.g. poor feeder roads and storage/ transport facilities in combination with perishable, bulky produce), as well as to changes in the demand or price (due to factors such as glut in the market at the time of harvest or lack of demand due to change in the consumption pattern). We discuss below a few strategies, which in our opinion will help address some of the market risk issues.

- Warehouse Finance

Warehouse finance clearly represents an opportunity to give farmer access to cheap finance on a post-harvest basis as well as allow him the opportunity to not be subjected to distress sale situations. This has enormous benefits for the small farmer because the large farmer is often able to hoard the commodity in case he has higher price expectations. It is the small farmer that needs to sell as soon as the crop is harvested. The warehouse receipt needs to be made a negotiable instrument. In the current form, banks are reluctant to lend to the small farmer, and when they do, lend at high interest rates. However, if the goods are sold forward on a futures exchange such as NCDEX where the goods are deposited in a warehouse (an electronic warehouse receipt is issued) and graded appropriately. As the goods are certified, there is no question on the grade and quality of the good. As it is sold in the futures market, the value of the future proceeds is fixed. The bank now does not carry any risk on such loans and can lend at a lower interest rates. Clearly, the farmer's holding power now increases, as he does not have to resort to distress sale any longer.

- Improved Price Discovery through exchanges and automated auction markets

One key driver of value for farmers in general but specifically for improving access to finance is the development of national warehouse receipt / spot market for both dry and wet goods. An NCDEX type platform²⁴ for limit-order matching type trades and a SAFAL type platform for Dutch and English Auctions are essential for these markets. All of the Mandi's need to be electronically linked

²⁴Futures exchanges, which already have the platform for efficient price discovery can actually also get into spot trading. Today the farmer has a bundled product in the mandi: price information, decision to sell, physical delivery and financial realization. Quite clearly he does not really have an option once he goes to the mandi where he has to sell the product at the offered price. But if we look at the NCDEX solution: the farmer views various spot prices (polled by NCDEX) in his village and decides where he has to sell his goods. He then goes to the terminal (there are over 8000 in the country today) and places the order. Once the order is placed, he moves to the mandi of his choice and delivers the goods. Financial realization is instantaneous once his commodity account is certified and the payment received from the buyer. For this the APMC laws need to be changed to permit futures exchanges to trade in commodities.

to these exchanges and prices made available to all the farmers. Through the whole Village Knowledge Centre proposal (and other similar internet based initiatives) trading platforms needs to be extended to the farthest corners of the country. In case of SAFAL, since there is need for a much larger market-yard infrastructure in other parts of the country as well, there is a need to promote the creation of a number of such markets but all with both physical and on-line auctioning capability (including from overseas) so that price discovery can happen on a local as well as national and global²⁵ basis.

- Banks to be permitted to Trade Agricultural Commodities²⁶

Since there is an expectation that banks will (a) provide large amounts of finance against crop risk and (b) extend outreach of financial services deep into rural India, it is imperative that they be permitted to trade these commodities directly on their own balance sheet (both domestically and cross-border) so that they can hedge out the risks that they already incur on their balance sheet, provide a larger proportion of current value as commodity finance to the small farmer and offer simpler financial products such as commodity forward contracts to those farmers that cannot afford to trade in the minimum lot sizes of the national exchanges - the current permissions make it impossible for the small and marginal farmer and the farmer without direct exports (but with similar price risks) to access these risk management instruments. In many situations buyers or sellers may need fixed price situations -rather than attempt to engineer them through hard-to-enforce contract-farming frameworks it may be better to allow financial intermediaries to launch longer-term fixed-floating commodity swap markets. Banks can act as an aggregator here and represent the farmers on the exchanges on a fee basis. Farmers would thus be able to trade on the exchanges. Further, by covering the farmer, the banks are also able to ensure that the credit risk in lending to the farmers is mitigated by selling on futures exchanges.

5. Expansion of Cheque Truncation facilities

Reserve Bank of India has suggested introduction of cheque truncation in clearing

²⁵The concept of an offshore exchange similar to the offshore banking unit could be permitted so that global price discovery can happen right here in India. Then those entities that are permitted to access international exchanges can trade with these offshore exchanges, which are physically, located right here in India.

²⁶Mor et al (2006)

house in New Delhi by December 2006. While presentation of cheques through image processing would reduce clearing time and expenses drastically bringing down cost of individual transaction, the real impact of truncation would be felt when out-station cheque collection would happen through truncation as it would reduce the time for encashment of instrument from average 10 days to 1 day and would eliminate the courier / postal cost and probabilities of losing of cheques.

6. Waiver of stamp duties on loan Agri documentations

Loan documentation attracts state stamp duty and it varies from Rs.100/- (for small loan) to Rs.300/- for agreement. Also security creation like mortgage attracts large stamp duty in several states. Waiver of stamp duty not only brings down documentary cost but would also enable execution of documents online using technology. With automation, the borrower can sign the documents through centralized documentation system and accept terms and conditions. This would result in reduction in cost of traveling to place of lender for execution of documents.

A stamp duty of Rs.300/- converts to 3% cost on loan value of Rs.10000/- and 1.2% for loan size of Rs.25000/-. But more than cost it is the difficulty in getting stamp papers in rural areas which delays lending and burdens borrower with cost of visiting nearest urban centers for procuring stamp papers.

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3 Annexures

3.1 Annexure 1: Processes for First Loan to a Group

The difference in two MFI selected for study was as follows.

Model 1	Model 2
Group Size: 4-5	Group Size: 14-20
Has been in use for last eight years	Has been in use for last two years
Financial Intermediary using monies borrowed from various banks for on lending	MFI works in partnership with a bank lending directly by bank to the end user with MFI acting as bank's partner
Field workers reports to Branch and Branch report to Dist office which reports to HO (Three tier)	Unit heads sit in the district office. Field worker reports to unit head who reports to district head who reports to head office (two sets of fixed cost)

The contributors to direct transaction cost:

	Model 1	Model 2
Group formation	32%	36%
Direct Admin. Activities	30%	35%
Monitoring	38%	29%
Total	100%	100%

On a typical loan size of Rs.8000/-, the total transaction cost for the first loan to a group was as follows.

	Model 1	Model 2
Direct Transaction Cost	6.2%	3.7%
Indirect Transaction Cost	5.1%	4.4%
Total Transaction Cost	11.3%	8.1%

However on the life cycle of 4 years, the composition of the total transaction cost significantly.

	Model 1	Model 2
Direct Transaction Cost	3.4%	1.9%
Indirect Transaction Cost	3.6%	3.1%
Total Transaction Cost	7.0%	5.0%