Need to Reduce Transaction Cost and Risk Cost in Rural Lending: Indian Context

***Santosh Kumar Raut**
Research Scholar
Department of Commerce and Business Administration
L. N. Mithila University, Darbhanga

****Dr. K K Choudhary**
Assistant Professor
Department of Commerce
Maharaja Laxmishwar Singh Memorial College, Darbhanga

Abstract

Risk in the banking parlance connotes the probability of loss of loans or investments. The methodology for determining risk costs is yet to be standardized, the age of over dues heavily influences risk costs. The cost involved in transferring resources between markets or between participants in the same market can be defined as a transaction cost. In financial markets, transaction costs refer to the resources required to transfer one unit of currency from the bank, which collects deposits from the savers or borrowers or from other sources on agreed terms, to a borrower and to recover that unit of currency at a later date with some agreed interest charge. Against this background, a modest attempt has been made in the present paper to discuss transaction cost and risk cost in rural lending. Further, the paper highlights about an urgent need to reduce these costs in rural lending.

Key Words: *Credit Rationing, Lending Costs, Risk Costs, Rural Lending, Transaction Costs.*

Introduction

Lending costs comprise transaction costs and risk costs. Transaction costs constitute a significant proportion of rural lending costs. These costs include all the cost required for deposit mobilization, servicing advances, recovery and all other banking operations and they aggregate to the cost of management.

One of the important impediments in rural credit is high over dues and attendant bad debts. Risk in the banking parlance connotes the probability of loss of loans or investments. The methodology for determining risk costs is yet to be standardized, the age of over dues heavily influences risk costs. The Agricultural Credit Review Committee (ACRC) has defined risk costs in terms of either loans written off or provisions made by the banks towards bad debts.

Transaction Costs

The cost involved in transferring resources between markets or between participants in the same market can be defined as a transaction cost. In financial markets, transaction costs refer to the resources required to transfer one unit of currency from the bank, which collects deposits from the savers or borrowers or from other sources on agreed terms, to a borrower and to recover that unit of currency at a later date with some agreed interest charge. Unlike transactions in other markets, financial transactions always involve greater risk because the contract is incomplete till a future date when the loan is repaid.

The costs incurred by all the participants, i.e. banks, financial intermediaries and borrowers in a loan transaction constitute the total costs. The level and distribution of these costs among the participants are affected by changes in technology, consumer preference, financial regulation, internal efficiencies of banks and financial intermediaries and the interaction of demand and supply of credit.

Bank Transaction Costs

Financial institutions incur the cost while raising funds, which includes the cost of mobilizing deposits, interest paid for the deposits and the cost of loan delivered. On the other side, the borrower pays the costs of loan negotiation and proof of his creditworthiness as also interest on the loan which he receives. The financial transaction cost is the interest paid by the bank on the deposits received from the savers, and on borrowings received from various sources. The cost of mobilizing deposits and the cost of lending are the major non-financing transaction costs incurred by banks. The former corresponds to the labour and material resources utilized in handling deposit accounts and in documentation and record keeping. The cost of lending refers to cost associated with identification of borrowers, loan processing, sanction disbursement, follow up, recoveries and record keeping. Assessment of the creditworthiness of the borrower forms part of the lending cost. The interest charged on loans represents the income earned by banks to cover interest paid on deposits, cost of mobilizing funds, cost of lending, and surplus for profits, which may be positive or negative.

Borrower Transaction Costs

Interest rate ceiling imposed by monetary authorities in regulated environment prevent the interest rate from moving to the market equilibrium rate. This results in excess demand for credit.

The restricted credit supply necessitates the banks apportioning the short supply among all those who demand credit This results in a more complicated credit delivery system involving various kinds of selections/screening procedures by lenders to decide the prospective borrowers. The process of assessing the creditworthiness of a borrower results in transaction costs to the bank, which increases the marginal cost of financial institutions. In most situations, these costs are passed on to the borrowers and transform themselves from bank transaction cost to borrower transaction costs. The borrower transaction costs deal with three major components:

I. Cost of loan negotiation, receipt and repayment which include the expenditure relating to travel and incidental expenses.
II. Documentation expenses, which include expenditure, incurred by the borrower in connection with obtaining necessary certificates from village authorities and no objection certificates from other banks.
III. Opportunity cost of time spent for negotiating loan which is estimated by imputing average prevalent wage rate.

Transaction Costs - Present Status

Transaction costs are also defined as implicit and explicit expenses incurred by participants in the financial market to affect financial transactions excluding interest payment of lender/intermediaries. The major components of the loan transaction cost are the following:

1. Identification of the borrowers-gathering and processing information required to screen borrowers
2. Collection of application and document verification - processing/examining collaterals.
3. Pre-sanction visit.
4. Loan appraisal, sanction, disbursement and maintaining accounts.
5. Post-sanction visit.
6. Monitoring, follow up and recoveries.
7. Other costs not enumerated above.

Transaction costs influence both lenders' and borrowers' behaviour and it is assumed that transaction costs are considered by borrowers as part of total loan prices. Under this situation the simultaneous equations model with transaction costs and loan demand as endogenous variable can be viewed as appropriate method of analysis.

The model as specified by Cuevas and Graham consists of two equations, (1) Loan demand equation, (2) Transaction costs equation.

(a) Loan Demand Equation

The loan demand equation is specified with the hypothesis that demand is determined by various factors, viz.:

1. Transaction cost of borrowing
2. Interest rate charged
3. Financial strength of the borrower
4. Borrower's liquidity requirements decided by family size, number of dependents and literacy level
5. Availing of credit from informal sources
6. Loan requested through intermediation of NGOs/SHGs.

(b) Transaction cost equation

Transaction costs are hypothesized to be determined by the following factors:

1. Size of loan applied by the borrower
2. The interest rate
3. The value of asset owned by borrower
4. Type of the bank
5. The proximity of borrower's residence to the bank
6. Quantum of loan expected with intermediation of NGOs/SHGS
7. Time lag in loan negotiations.

The initial transaction costs of lending, i.e. the interest rates are at present deregulated to a large extent. However, the other transaction costs are contingent upon the loan accounts and the size of loans. These transaction costs rise, when the number of small loans increases but fall, with an increase in loan size. Location of bank branch, its proximity to the borrower's village, closeness to market centre are other factors influencing the transaction costs of rural lending. Intermediation helps the bank branches in more than one way, like in identification of borrowers, documentation, supervision, follow up and recovery. These aspects considerably reduce transaction costs of lending by banks.

The simultaneous equation model can be used to quantity the influence of various factors of borrower transaction costs in rural credit, keeping loan demand and transaction costs as endogenous variables. The a priori assumption is of an inverse relationship between transaction costs and interest rates on one hand and loan demand on the other, since such costs always decrease as volume of loan demand increases. The asset value, the family size, literacy level and intermediation of NGOs/SHGS (indicating the level of awareness of borrowers) are some of the major variables which are expected to show a possible relationship on loan demand. The transaction costs variable is an important determinant of loan demand. For the borrower, the transaction costs add to the outlay and cause them to borrow less as their out of pocket expenses and cost of time spent on loan negotiating increases. The value of assets is a significant variable in the loan demand equation and expresses a positive relationship. There is also a significant relationship between the type of bank and the loan demand variables.

Considering all Transaction Costs

The first type of transaction costs - administrative or managerial, usually includes costs of personnel, office space, postage, stationery, printing, travel, audits, training and related maintenance costs. To make these costs comparable across Rural Financial Institutions (RF1s) within a country or over various countries, they should be defined in unit or percentage terms. The normal convention is to express thesis, there laonable resources, i.e., on the liabilities side of balance sheet of an RFI. This implies that only laonable funds are an output of every RFI. But actually the output of an RFI should be defined as all assets plus all liabilities for two reasons - first, asset items such as loans and investments are obviously the outputs of an RFI and second, liabilities are also an output because of the joint nature of assets and liabilities of financial institution.

Unit transaction costs are, therefore, defined as total transaction costs as a percentage of all liabilities plus assets excluding contra items such as bills, drafts of other banks and guarantees. It is important to recognize that any financial institution has financial costs besides the transaction costs required for its business. These costs plus the transaction costs make up the total cost.

These cost and revenues must be in unit term. Like transaction costs, other costs like financial costs and also gross revenue must be measured in unit or percentage terms, which would then express average financial cost and average gross revenue.

The difference between average gross revenue and average financial cost can be termed average gross margin. If gross margin is higher than average transaction cost, the RFI is viable. If gross margin is lower than average transaction cost, the RFI is not viable and if average gross margin and average transaction costs are the same, the RFI breaks even.

Reducing Transaction Costs

The studies carried out in Indian context reveal that Transaction Costs are high in case of an RRB and low in case of an SCARDB. This emphasizes the fact that Transaction Costs are related to the volume of loaning business.

Measurement of transaction costs should not be in absolute terms, but in relative terms as a percentage, so that it can be compared with all types of institutions across the countries. Estimation of transaction costs of lending and comparing them between different types of lending and between different types of institutions per se may be necessary to estimate the profitability of taking up certain lending activities or not. But beyond that, these costs may not be used to compare the viability of institution as such. Because RFIs do not deal with loan products alone, but with a variety of products, to compare the viability aspects the cost of institutions as a whole has to be considered.

The institutions can try to reduce the impact of transaction costs on viability by increasing the levels and volume of their operations, transaction cost per se can also be reduced with an improvement in various systems and processes. This improvement has to be in the following areas:

- Reduction of time taken for processing loan proposals.
- Improvement in the loan processing system by simplifying procedures, documentation and other paper work.
- Improvement in the quality of loaning by better pre sanction appraisal; this would lead to lesser time on loan supervision.
- Devise easier and cost efficient loan follow up and supervision system so that less time and manpower would be spent on that.

In addition to this, banks can also consider intermediation by NGOs/SHGs. This has been found to be very effective in reducing the cost involved in loan processing and administration and have considerably reduced the transaction costs in lending.

One of the study has found that per Rs. 100/- transaction costs could be reduced substantially due to intermediation by NGOs/SHGs. Banks, especially RFIs should try to make use of this possibility of reducing transaction costs.

Further, the definition of Agricultural Credit Review Committee (ACRC) of measuring viability through net margin in lending arrived at after estimating the transaction costs, with addition of cost of funds has certain inherent shortcomings. The viability is of an institution rather than of any single service like loaning. The institution not only loans but also borrows and mobilizes deposits, besides providing other services. Many of these operations are joint and complementary. As such, transaction costs are common to all services. Their allocation to lending alone is artificial, arbitrary and fraught with assumptions that can prove to be misleading. A better alternative would be to look at the total asset/liability positions of the institutions or the units and their costs and returns as compared to the cost of management of the institutions. This type of analysis will show a better picture of the actual level of viability of banking institutions or its units.

The viability of banking institutions is also a function of the volume of operations rather than of only the margins available. The existence of scale economies in RFIs reveals that their average transaction/ administrative costs (i.e. per Rs. 100 of business volume) are declining and/or constant. This implies that these institutions would improve their viability through increase in business volume rather than the increase in their gross margin. With the increase in the volume of business, with the cost of management remaining the same the unit of banking can indeed be viable. So, aiming for an increased volume of business operations of banking institutions especially rural banking institutions or units would be a major plan of action for the units which are non-viable. This fact is borne out even by the observations of ACRC that the quantitative expansion and qualitative improvement of scale increasingly, thereby resulting in lower per unit cost of management and consequently higher margins and profitability.

It may also be realized that viability is mainly related to business related factors, viz., low level of deposits and unbalanced mix, low level of advances and non-profitable composition, and inefficient management of cash and bank balance. So, any strategy to make rural banking operations viable should address the above business issues and not the issue of transaction costs alone.

Risk Costs in Rural Lending

Risk cost in rural lending is a premium, which lenders charge all borrowers to compensate for default by some borrowers. Its size depends, therefore, on default rate which in turn depends on the extent to which such risk reducing mechanisms are prevalent. These include credit rationing (which excludes certain types of risky borrowers and loans altogether), and the use of collateral to strengthen repayment incentives. Other ways of reducing risk are to make smaller and shorter loans, lend to more credit worthy borrowers and lend for purposes that will strengthen the ability to repay. Risk premium, depends not only on the riskiness of a loan but also on a host of other factors.

The increasing default trend poses a serious problem to banks. This results in high risk cost and hence this cost has to be considered in the context of bank viability. The risk premium is quantified in terms of default risk.

Poor recovery due to non-payment of dues is an area of major concern to the institutional credit Poor recovery do sometimes, the recovery performance of all banking in expectation of fructed by the implementation of agricultural and rural debt relief scheme. The borrowers' expectation of further relief programmes by the governments affects the recovery performance of institutional credit. This situation adds to a new dimension in the estimation of transaction costs of lending necessitating a need to quantify the risk costs involved due to increase in the default rate. Efforts have already been made to quantify risk costs in order to make a realistic assessment of the total lending costs of rural credit. The report of Agricultural Credit Review Committee visualized risk cost as actual write off or provision made for bad and doubtful debts. It used the claims paid by DICGC for approximating bad debts. The extent of default has been identified as the main criteria for estimating the default risk. The loss of principal and uncollected interest, the administration cost incurred in handling the loans in default and the cost of funds deployed as a consequence of default are all summarized as default risk.

Rural Financial Institutions often fail to write off bad loans because of legal restrictions or the desire to show exaggerated profits. When bad debts are not written off, the reported loan recovery performance may be highly distorted. The longevity of an RFI is largely a function of its ability to manage risk successfully. The three categories of risk that characterize RFIs are:

1. **Subsidy Risk:** Dependence on subsidies threatens the longevity of RFIs and subjects them and their clients to risk in the form of possible variations, especially reduction in future subsidized funds. This risk can be mitigated by measures that reduce dependence on subsidies.
2. **Covariant Risk:** RFIs are subjected to high covariant risk in lending to their target clientele since the rural economy is highly influenced by agriculture, which is seasonal and subject to covariant shocks. The solution is to diversify to the extent possible and to forge links with financial intermediaries in other areas (including urban areas).
3. **Default Risk:** Challenging co-variant risk and information and enforcement barriers in rural areas expose RFIs to higher default risk. These risks can be reduced by carefully using joint liability mechanisms, providing incentives for timely repayment (an interest rate rebate, for example) and carefully monitoring loan performance. Making adequate provisions for doubtful loans and including appropriate risk premiums in lending rates will help RFIs to cope with this risk and reduce the likelihood of financial distress. Credit guarantee schemes have been introduced by some governments to reduce RFIs risks and encourage them to lend to customers with insufficient collateral.

Risk Cost - Present Status

The most obvious manifestation of risk in credit programmes is poor portfolio quality that leads to bad debt losses and erodes the capital of the lending institutions. At one level, failure occurs because of unexpected events that were not forecast. These events are often bad agricultural years; unforeseen increases in the cost of industrial production; and lack of markets for the skills, products and services supported by credit. Opportunistic behaviour by borrowers who refuse to repay and the unwillingness or inability of lenders to exert meaningful sanctions against such borrowers, also leads to such risk manifestation. At ta more profound level the manifestation of risk suggests shortcomings in the design of the institutions.

Efforts are also required to manage the lender risk. Lenders can reschedule loans, provide additional credit, develop savings facilities to provide alternatives for borrowers who are also depositors, alter loan size raise interest rates to offset credit and use any leverage that may be available to foreclose on security.

Risk management by lenders requires attention to liquidity. When adversity strikes, borrowers are less likely to repay and depositors may like to withdraw from their savings balances. Risk exists because things do not always work out as planned. Planning how to manage risk that affects credit programmes has positive benefits for all concerned. Planning helps the lenders and others to accumulate knowledge about the problems faced by borrowers and how these problems can be managed. It encourages the lender to build robust systems for managing relationship with borrowers and the portfolios, the relationships generate. Efforts at risk management through improvements in credit project designs enable in the contribution of developing a more sensible manner of project designs by making them more responsive.

ACRC has estimated an approximate risk cost of 1% for various RFIs functioning at the field level. This is based on three approaches: (1) Proportion of reserves created for bad and doubtful debts, (2) Proportion of over dues over three years to demand, and (3) amount of claims paid by the DICGC (in respect of RRBs and (CBs).

Measures to Reduce Risk Costs

The risk costs in rural lending are substantial and they do have a negative impact on the viability of RFIs. Some of the measures which RFIs could adopt to bring down the risk cost may include the following:

- Lending must be initiated to meet the bankable demand for credit (as opposed to being supply-led).
- Clients must be carefully selected and screened, asking for character reference and forming groups can offset the lack of information about potential borrowers.
- Alternative forms of collateral, such as joint liability, should be accepted..
- Foreclosure should be exercised (where legally possible) in instances of default. Although foreclosing may not always be cost-effective, particularly for small loans, it can deter wilful default by other clients.
- Loan size should be carefully evaluated and gradually increased according to the client's repayment performance, earnings, and debt-carrying capacity.
- Loan terms should meet the needs of the client, be flexible, and be convenient in relation to the re-payment schedule, instalment amounts, and location of payments.

- The loan contract must be clear, simple and explicit.
- The effective interest rate should be quoted to the client.
- A positive real on-lending interest rate must be charged so that the loan is not perceived as a grant.
- Arrangements with the government (especially for interest payments) should be transparent.
- The RFI can mobilize savings where permitted this may give the client a sense of ownership of the loanable funds and of the institution.
- Clients could be rewarded (through interest rate rebates or access to larger future loans) for timely repayment and penalized (through fore-closure and denial of future access to loans) for defaulting.
- Staff could be given incentives (through profit sharing and promotion for performance) for high loan collection performance.
- Loan performance may be monitored daily through a well-developed management information system - arrear should be investigated immediately by the loan officers responsible for managing the account.
- Rent-seeking by staff (fraud and bribery) should be detected and prevented by requiring managers and internal auditors to monitor staff, by providing staff incentives and competitive remuneration, and by eliminating opportunities for arbitrage afforded by below-market on lending interest rates.
- Covariance risk associated with loan portfolio should be reduced through diversification of loans in relation to clients and client groups, lines of activity (by lending for agriculture and non-farm activities), loan maturities, and location of clients. Prudent maximum ratios should be established relative to net worth.

It may, therefore, be observed that there is a substantial reduction in risk costs due to intermediation. This reduction is because of the fact that the resources lent at the group level are viewed and treated as the community's and the groups own resources, which have to be returned in time. There is also a factor of peer pressure which force the group members to be regular is repayment. Banks, especially RFIs should increasingly think in terms of adopting the group approach to lending wherever possible so that the risk cost could be brought to very negligible levels.

Summing-up

Transaction Cost and Risk Cost comprise a major proportion of rural lending costs. But, the concept of estimating the viability of an institution directly by the Net Margin method based on Transaction Costs and Risk Costs has certain shortcomings. Unit Transaction Costs are not static as they reduce with increase in the volume of business, further transaction costs of lending alone cannot be viewed separately as the ost of management of the institution as whole has to be considered. The concept of lending transaction custs is useful to assess the profitability of each type of lending activity so as to decide whether, the banks should take up that activity or not.

Risk Costs are related to the level of default in banking institutions. With the standardization of provisioning norms, they could be considered for the estimation of default risk. Several methods are suggested for hanks to reduce default rate and thereby risk cost.

Intermediation through SHGs/NGOs could be an effective method of reducing risk costs and transaction costs in rural lending. Several studies vouch for this fact and banks should increasingly view this as a method of reducing transaction costs and risk costs in rural lending.

References:

1. *Desai, S S M (1979), Rural Banking in India, Himalaya Publishing House, Bombay.*
2. *Mahajan, M C (2015), Rural Banking and Agriculture Finance in India, Yadav Publication, New Delhi.*
3. *Purvey, Ramashish (2009), Changing Face of Rural Credit in India, Serials Publications, Delhi.*
4. *Ravichandran, K and Bala, M. Revathi (2008), Rural Credit: Access, Use and Repayment, Abhijeet Publications, New Delhi.*
5. *Sankhala, Dayalal (2024), Rural Credit System in India: Institutional Financing, Asian Journal of Management and Commerce, Vol. 5, No.1, January, pp. 106-109.*
6. *Savaraiah, G (1988), Rural Banking in India: An Empirical Study, Daya Publishing House, Delhi.*
7. *Singh, Bhagirath (2001), Rural Finance, RBSA Publishers, Jaipur.*
8. *www.apraca.org*
9. *www.nirdpr.org.in*
10. *www.rbi.org.in*
11. *www.worldbank.org*