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[Review]

Interest Rate Caps in Microfinance: Issues and Challenges

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Abstract

Purpose - To control exorbitant interest rates, implementation of an interest rate ceiling is a standard practice in microfinance. However, there are pros and cons of such market intervention. Hence, the aim of this short note is to highlight issues and challenges regarding the interest rate cap in microfinance, both from the perspective of clients and institutions.

Research design, data, and methodology - While the nature of this short note is explanatory and descriptive, the research methodology used relevant data from the MixMarket and Microcredit Regulatory Authority (MRA) annual reports in Bangladesh.

Results - We argue that an interest rate ceiling is detrimental both for the clients and microfinance institutions (MFIs). This market intervention substantially reduces the outreach of MFIs and clients are most likely to pay a higher price in the long-run. Additionally, an interest rate cap also puts severe pressure on new-born and high-cost MFIs to cope with the interest rate ceiling.

Conclusions - Although market intervention may be necessary in the short-run, it should not be the ultimate solution to abate high interest in microfinance. Understanding the operational dynamics of MFIs, as well as promoting productivity, efficiency and competition could help to lower the interest rates.

Keywords: Microfinance Institutions, Interest Rate Caps, Social Outreach, Developing Country, Bangladesh.

JEL Classifications: E43, G21, O23.

1. Introduction

The original promise of microfinance institutions (MFIs) is to provide affordable financial services to the poor. According to the United Nations Capital Development Fund (2016), "is achieved when all individuals and businesses have access to and can effectively use a broad range of financial services that are provided responsibly, and at reasonable cost, by sustainable institutions in a well-regulated environment". Despite the success and rapid growth of the microcredit industry (Mia, 2016), however, there has been very little sign of any abatement of high interest rates for the poor. Hence, the behavior of MFIs in charging high and exploitative interest rates not only rescinds the consumer benefits and impedes the overall socio-economic development of the poor, but also deviates from the path of financial inclusion. Regarding the pricing of microfinance loans, Professor Yunus (2007) suggests that, "a true microcredit organization must keep its interest rate as close to the cost-of-funds as possible... microcredit interest rates can be comfortably under the cost of funds plus ten percent, or plus fifteen percent at the most."

However, not all the MFIs follow the principle of Yunus or adhere to the original promise of microfinance as an informal banking initiation. There are some profit-making MFIs that charge high interest rates to attain financial gain. To control for such high pricing of microfinance loan products, the interest rate cap emerged as a common practice in the industry. There are two contrasting thoughts from the two different schools in microfinance. Institutionalism argues that charging high interest rates will provide financial sustainability

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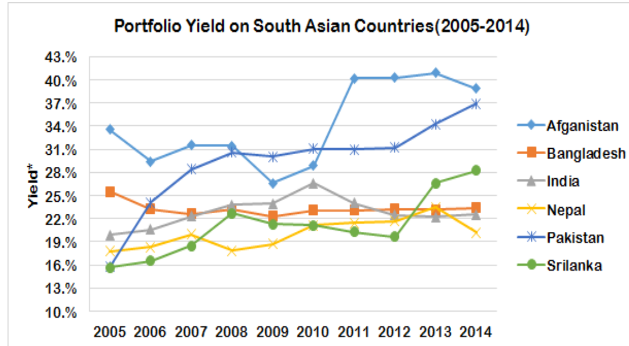
or operational self-sufficiency to the MFIs. This school of thought also further explains that surplus units of profit will be channeled to expand the business, which will ensure the long-term sustainability of the sector. Hence, supporters of institutionalism are most likely to oppose the implementation of interest caps. On the other hand, high interest rate has never been welcomed by welfarists who always support preserving the well-being of the poor through low-interest rates. These diverse opinions of the welfarists and institutionalists concerning interest rate in microfinance has generated heated debate and created complexity in microfinance operations. Policy makers have tried to handle these two extremes by intervening in the market, and one of the most preferred courses of action is capping the interest rate.

The Microcredit Regulatory Authority (MRA)capped the interest rate at 27% per annum (declining basis) in 2010, effective from July 2011 in the Bangladesh microfinance industry, upholding the prevailing aim to protect consumer welfare(Ahmed, 2013). A similar type of interest rate cap has been implemented in many countries, notably, India, Uganda, Morocco, Tunisia, Algeria, Libya, Egypt, and a number of West African countries (e.g., Ghana, Nigeria, Senegal, etc.). In general, these interest caps usually range from 25% to 35%, which is still far higher than the banking sector threshold. In 2014, however, the Reserve Bank of India (Central Bank) lifted the interest cap from microfinance activities that had been imposed in 2010.The aim of lifting the interest cap was to provide leeway to the lenders for them to charge interest according to their cost of operation with a determined margin. MFIs and their associates particularly welcomed the move despite criticisms from welfarists. The removal of interest caps in India could have been motivated by the fact that controlling the vast informal sector of microfinance requires a huge amount of resources, particularly in terms of manpower and strong institutional enforcement. As an informal lending service, the regulatory authority of the microfinance sector has a lack of such resources not only in India, but perhaps in all developing countries.

The primary justification and argument for interest rate caps is that some of the MFIs charge exorbitant interest rates to their clients –the usury argument indicates market failure. Hence, the authorities in Bangladesh came forward to intervene and correct market imperfections. Certainly, the market intervention is necessary when the market does not behave accordingly; however, the effectiveness and appropriateness of such policy intervention raise doubts among the decision makers and practitioners. When there is a market cap, it affects the demand and supply side of the market and generates a new equilibrium. Thus, it is important to understand the appropriateness and effectiveness of the market cap, or else, it may create more problems than solutions. <Figure 1> shows the trend of interest rates in South Asian countries.



Source: Authors' calculation from MixMarket.
*Average yearly nominal yield on gross portfolio.

<Figure 1> Micro-finance interest rates in selected South Asian countries (2005-2014).

2. Issues and Challenges of Interest Caps in Microfinance

Since interest caps is a controversial issue, thus, any authority that aims to implement this policy in the market should perform a comprehensive benefit-cost analysis before implementing it in the market. Generally, interest rate ceilings always hurt the poor and distort the overall market (CGAP, 2004; Mohane, Coetzee, & Grant, 2000). With respect to other industries, interest rate ceilings in the environment of overall rising interest rates is not sustainable in the long-run and provides extra financial burden towards the high-cost borrowing, particularly for newly-formed MFIs (CGAP, 2004). In the context of the Bangladesh microfinance industry, there are at least five main reasons why an interest rate cap is not a viable solution for the long-term sustainability of the sector. The following section provides a brief overview of the arguments based on the Bangladesh context. However, the implications of this note are also applicable to other developing countries due to aspects of homogeneity in microfinance industries across different nations.

1) One of the major drawbacks of an interest rate cap is that it substantially reduces social outreach (providing financial services to the poorest of the poor) of MFIs. With a cap on the interest rate, MFIs will be less interested in funding loans of small amounts due to the high cost of operations and monitoring expenses. Intuitively, they will find it cost effective and profitable to allocate larger loans to maintain the balance between revenue and cost. By doing so, the lower end of the poor, who require smaller loans, will find it difficult to obtain finance capital for their business ventures.

2) For financial markets in some of the developed countries, the cap will indeed increase the interest rates in the long-run, and this will perhaps be the case in the developing world as well. One of the examples is the interest rate cap in Colorado (DeYoung & Phillips, 2006), which seemed to lower interest at the beginning stages of implementation, however, it has gradually increased interest over the years due to implicit collusion among the players (Miller, 2013). A similar kind of effect is also vital for the microfinance sector in Bangladesh, where the top 10 MFIs leading the industry already charge interest rates higher than the industry average (MRA, 2015).

3) Any influence on the market, either fiscal or monetary, will distort the overall market as argued earlier. The MRA set the interest rate cap at 27%, which is still 10-15% higher than that of the formal banking sector. The rate was not appropriate because low-cost MFIs also tend to increase their price up to the cap, whereas high-cost MFIs may not survive with such requirements. Nonetheless, due to the adverse selection resulting from the interest cap, MFIs will lose their power to discriminate price. In addition, riskier business ventures will not be able to secure any funds, thus hurting the poor financially.

4) The flat market rate in the Bangladesh microfinance sector is not appropriate in a context where there are different types of loans with various interest rates. This has resulted in the unification of the interest rates and provided an opportunity for MFIs to increase their low-cost loans (subsidized by donations, concessionary loans etc.) to its maximum. For example, the average portfolio interest rates in the microfinance industry in Bangladesh range from 23% to a little over 25%. MFIs which previously charged interest rates lower than the market cap will now be motivated to increase their interest rates up to the ceiling. If the authorities really resolve to implement a market cap, it should be varied based on loan size or the types of loans, instead of a rigid interest cap. The intuition behind such a cap will bite various levels of the market, as well as minimize the consumer surplus and financial burden of the lower-end poor (Miller, 2013).

5) The main backdrop for inefficient interest caps is the weak and low institutional capacities of regulatory authorities and other associated parties involved in the sector. It would be somewhat difficult for the relatively new-born MRA to effectively implement the interest rate cap countrywide due to the considerable size of the sector. This market intervention requires significant human resources, fiscal strength, and willingness of other associated parties, which is found to be insufficient in the current context. Based on the data provided by the MRA, there are a total of 63-65 personnel currently working in MRA, headed by an Executive Vice Chairman and a board of 7-8 directors. Among these staff members, 9 of them are in charge of onsite supervision and 4 of them are in charge of audit and off-site supervision. This modest workforce is certainly insufficient to supervise and control the whole sector with over 33 million clients and 700 MFIs(MRA, 2015).

3. Conclusions

Generally, implementing an interest cap in the microfinance sector to control high interest rates should not be regarded as a perfect solution. Although this approach may work for a short period, weak regulatory enforcement and lack of necessary resources for effective implementation pose major challenges in the long-run, particularly for developing economies. Moreover, an interest rate cap further deteriorates the aim of social outreach, leaving the poorest of the poor out of financial services. Hence, countries seeking to control interest rates through interest caps in microfinance should be cautious of the concomitant effects.

If the authorities really commit to bring down interest rates in the long run, it should be executed in a sustainable manner. For example, components that can drive this credit program to be sustainable in the long-run include the investigation of market structure, productivity, and efficiency. MFIs should lower their interest rates by improving their efficiency, productivity and through enhancing competition in the sector (Goodwin-Groen, 2002). A competitive microfinance industry will enhance productivity triggered by innovations and technological advancement; this will, in turn, minimize the cost of operation, thus lowering interest rates amalgamated from efficient and prudent utilization of the resources. Then, the authorities can effectively control the interest rate through promoting competition and productivity with various financial and non-financial packages (Maimbo & Henriquez Gallegos, 2014). However, there is scant literature that examines the effect of market structure and productivity on interest rates. Therefore, future studies should focus on the empirical analysis of such nexus to provide relevant policy guidelines for long-term sustainability of the sector.

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