Impact of Restrictions on Interest Rates in Microfinance

The paper examines the impact of restrictions on interest rates in microfinance. The issue that interest rate restrictions attempt to address is one of social welfare: how to enable low-income families to obtain access to finance at a price that is acceptable to society. If imposing of restrictions on interest rates in microfinance is not the best means of enhancing social welfare for enabling low-income families to obtain finance at a reasonable price, then what is? The simplistic economist’s answer to this involves economies of scale, which can work in one of three ways. First, by increasing loan size it should be possible to bring down the average price of loans. Second, economic theory suggests that by expanding the amount of activity it should be possible to bring average costs down. And finally, promoting competition is another way of reducing costs and/or squeezing the margin earned by microfinance institutions.

About the Asian Development Bank

ADB’s vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region’s many successes, it remains home to half of the world’s extreme poor. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.
Impact of Restrictions on Interest Rates in Microfinance

Sanjay Sinha provided inputs to the working paper. Sinha is the Managing Director of Micro-Credit Ratings International Limited, India.
# CONTENTS

TABLES AND FIGURES ............................................................................................................................... iv

ABBREVIATIONS ........................................................................................................................................ v

1. INTRODUCTION—THE LURE OF RESTRICTING INTEREST RATES IN MICROFINANCE .......................................................................................................................... 1
1.1 The Argument for Restricting Rates .............................................................. 1
1.2 The Rationale for Higher Interest Rates in Microfinance ......................... 1
1.3 The Counterargument ................................................................................. 2

2. INTEREST RATE RESTRICTIONS—WHERE, WHAT, AND HOW ................................. 3
2.1 Interest Rate Restrictions in Developing and Emerging Market Economies .... 4
2.2 Restrictions on Consumer Lending Rates in Developed Economies .......... 5

3. THE IMPACT—REPRESSION AS FREEDOM ............................................................................. 7
3.1 Effect on the Demand for Microcredit ......................................................... 8
3.2 Effect on the Supply of Microcredit .............................................................. 9

4. CONCLUSION—RECLAIMING THE WELFARE OBJECTIVE ........................................ 14
4.1 Economies of Scale ................................................................................... 15
4.2 Competition ................................................................................................ 17
4.3 Can the Welfare Objective be Reclaimed? ................................................... 18

REFERENCES ............................................................................................................................................ 21
# TABLES AND FIGURES

## TABLES

2.1 Types of Interest Rate Controls on Microfinance ................................................................. 5
2.2 Interest Rate Ceilings in Developing Countries ................................................................. 5
2.3 Interest Rate Restrictions in the European Union ............................................................ 6
2.4 Status of Interest Rate Restrictions on Consumer Lending in Major Developed Economies ... 6
3.1 Restrictions on Fees and Loan Insurance in the European Union ....................................... 14

## FIGURES

1 Comparative Cost Structure of Banks vs. Microfinance Institutions (MFI) in India .......... 1
2 Demand–Supply Disequilibrium under Interest Rate Repression ......................................... 7
3 Average Loan Balances at SafeSave Branches Before and After an Interest Rate Increase, 1999–2000 ................................................................. 8
4 Microfinance Market Penetration (With and Without Interest Rate Ceilings) ................. 10
5a Status of Consumer Loans, Jan 2006–Nov 2007 ............................................................... 11
5b Consumer Loan Acceptance Ratio in Japan, 2006–2007 ..................................................... 11
6a Germany: Share of Sparkassen Lending to High Risk Borrowers by Income Range .......... 12
6b Access to Overdraft Facilities for Low-Income Consumers in Germany ........................... 12
7 Operating Expense Ratio Trends in Select Asian Countries ............................................. 16
8 Evolution of Microcredit Interest Rates in Bolivia, 1992–2007 ........................................... 18
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>APR</td>
<td>Annual percentage rate</td>
</tr>
<tr>
<td>BCEAO</td>
<td>Central Bank of West Africa</td>
</tr>
<tr>
<td>CGAP</td>
<td>Consultative Group to Assist the Poor</td>
</tr>
<tr>
<td>CU</td>
<td>credit union</td>
</tr>
<tr>
<td>GE</td>
<td>Geneva</td>
</tr>
<tr>
<td>IIR</td>
<td>interest rate restrictions</td>
</tr>
<tr>
<td>MFI</td>
<td>microfinance institution</td>
</tr>
<tr>
<td>MIX</td>
<td>Microfinance Information Exchange</td>
</tr>
<tr>
<td>NGO</td>
<td>nongovernment organization</td>
</tr>
<tr>
<td>OER</td>
<td>operating expense ratio</td>
</tr>
<tr>
<td>PAR</td>
<td>portfolio-at-risk</td>
</tr>
<tr>
<td>PPI</td>
<td>payment protection insurance</td>
</tr>
<tr>
<td>TIKAI</td>
<td>Tikkapara and Kalyanpur</td>
</tr>
<tr>
<td>UEAC</td>
<td>L’Union Economique de l’Afrique Centrale</td>
</tr>
<tr>
<td>UMOA</td>
<td>Union Monétaire Ouest Africaine</td>
</tr>
</tbody>
</table>
1. INTRODUCTION—THE LURE OF RESTRICTING INTEREST RATES IN MICROFINANCE

1.1 The Argument for Restricting Rates

In a world of declining (but nevertheless substantial) poverty, the welfare of low-income families continues to play upon the conscience, if not necessarily the daily conduct, of those who are more fortunate. For this reason, the argument goes, all that can be done to ease the economic burden of the poor must be done. Public distribution systems for the supply of subsidized food grains, employment guarantee schemes, and direct cash subsidies, among other schemes, are popular with the general public as support programs for the poor; equally popular are restrictions on interest rates in small (including micro-) finance. Reducing the price of debt by restricting the interest rate is in the same category as reducing the price of food grains, ensuring a basic minimum of labor opportunities and enhancing the cash inflow of the poor (albeit via hand-outs).

Indeed, because interest rate restrictions apparently impose no burdens on the exchequer, these are even more popular than the other poverty-easing measures. Since microfinance lenders are seen to charge higher rates of interest than typical bank lending rates they are presumed to be exploitative, particularly since these high rates are charged to people at the low-end of the income scale who are presumed to be the least able to bear the burden. Since the thinking is, “why should the poor pay more for debt than other sections of society,” the lure of restricting interest rates in microfinance is very strong. The temptation for populist politicians to pander to this perception is even stronger.

1.2 The Rationale for Higher Interest Rates in Microfinance

The perception of the general public vis-à-vis microfinance interest rates is apparently based on a mirage. Microfinance institutions (MFIs) worldwide charge higher interest rates than do banks for their typical loan. They do so (mostly) on account of the realities of the microfinance business. As an
example, Figure 1 provides a comparison of the typical cost structure of commercial banks versus MFIs. As the figure shows, MFIs have higher costs of funds, operation expenses, and profit margins.

1 Costs of funds. Over 40% of the funds of MFIs in Bangladesh come from deposits and just 8% from banks, but the overall cost of funds averages 7%, with the Grameen Bank paying as much as 12% interest on its client deposits. MFIs in the Philippines have higher levels of debt funding and pay interest at rates of 12% and above. MFIs in India typically borrow from banks since they are not allowed to raise deposits; as a result, 75% of all MFI funds in India tends to come from bank borrowing. The 2015 average of 14% paid by MFIs in India on borrowed funds results in an average cost of funds of 10.5%.

2 Operating expenses. The operating expense ratio (OER) is 12.5% for the most efficient MFIs in India. Even higher levels of 23%–25% are found in Pakistan, and ratios of over 40% exist in the Philippines. This compares with averages of 3.5%–4.0% for commercial banks and results from servicing average loan sizes (around $250) that are a fraction of the amount of commercial banks ($25,000 and more). Apart from the small loan size they offer, MFIs deliver services in the neighbourhood or village of the borrower (“doorstep delivery”), compared with the branch-based service delivery model of commercial banks.

3 Profit rates. MFIs’ profit rates are higher than commercial banks due to the need for MFIs to attract investors to a business seen by the public as inherently risky and also to generate a significant enough surplus to finance growth. Thus, in terms of returns on assets, MFIs must earn at least 2%–3% compared with the typical profit margin of 1.0%–1.5% for most commercial banking systems in developing Asia.

1.3 The Counterargument

Critics of microfinance respond that, as institutions ostensibly driven by a social mission, MFIs should

- not expect to earn a profit (at all!), relying entirely on philanthropy or government support to raise equity capital for their operations;
- find ways of reducing operating expenses via cost-cutting (e.g., reductions in management and staff salaries, and travel expenses) and realizing economies of scale so that their OERs are reduced well below 10%; and
- cross-subsidize microloans by lending to larger borrowers in the small and medium-sized enterprise (SME) sector if necessary.

MFIs are accused, in particular, of being inefficient and earning profits at unreasonable levels with a view to exploiting the ignorance of the poor. This is presumed to be a means of the “sharp operators” who run or invest in MFIs to line their pockets. Such people are said to have become “new moneylenders” in the guise of socially conscious managers and investors. This rationale for restrictions on interest rates in microfinance (or small consumer finance) has led to action in many countries to impose limits (ceilings) on interest rates in microfinance.

---

1 This is based on the author’s knowledge and experience of the financial system in India. Similar cost structures exist in many other developing countries.

2 Operating expense ratio = Total operating (i.e., personnel and administrative) expense/average gross loan portfolio
Section 2 of this paper documents the actual restrictions that have been imposed in microfinance in many less developed countries and in lending to low-income consumers in developed economies. Section 3 examines the available evidence on the impact of these restrictions. Section 4 discusses ways of reclaiming the objective of serving the financial needs of low-income families in a socially conscious way while, at least partly, addressing the concerns of the public and the political establishment for the welfare of low-income borrowers.

2. INTEREST RATE RESTRICTIONS—WHERE, WHAT, AND HOW

As indicated in the Introduction, interest rate restrictions in microfinance have been applied not just in many developing countries, but also in developed economies where there is a parallel concern to protect low-income (often short-term) borrowers from the potentially predatory practices of lenders of small sums of money. Though the basic nature of micro-lending in the two types of economies is similar, the absolute amounts of the loans made and the apparent purpose of the loans are different:

- **Developing and emerging market economies.** Microfinance loans range from $50 to $500 in many developing economies in Asia and Africa, $1,000–$3,000 in Latin America, and up to $10,000 in Eastern Europe and the former Soviet Union. More importantly, such loans are presumed (unless otherwise stated) to be for the purpose of investment in economic enterprises of some sort (e.g., trading, production, services).

- **Developed economies.** Small loans outside the banking system are presumed to be for consumer finance and can range upward from $500 to amounts of $10,000 and more. A significant proportion of such loans are “payday” loans—credit provided against a promise to pay on the date when salaries or wages are paid to the borrower by his employer.

In practice, there is significant overlap in the purpose of such micro- and small loans in the two types of economies. The exclusive use of microfinance loans in developing economies for productive purposes is a myth that ignores the fungibility of money. Nothing prevents a small provision store operator from running down the stocks of merchandise in her shop in order to buy a new TV and then taking a loan from an MFI in order to replenish those stocks. In this situation, is the loan for productive purposes or is it, in reality, a consumer loan for the purchase of a TV? Thus, a significant proportion of microfinance loans may be used for consumption purposes.

Similarly, in the case of consumer lending in developed economies, the operator of a “dollar store” in New York City may not be able to obtain a loan from a bank due to the lack of both satisfactory collateral and of a credit history. In order to increase stocks in her shop then, a short-term loan from a non-bank lender may be the only way of expanding the business. Such a loan may, in most cases, be regularly serviced from cash flows from the shop but would be classified in macro-economic terms as a consumer loan due to the nature of the lender. As in the case of microfinance, due to the nature of the lender’s business, data on the use of such credit for productive purposes is unknown.

Despite this convergence between micro- and small lending in the two types of economies, because of the presumed difference between the two they are treated separately in the economic literature and are presented separately in some places in this discussion.
2.1 Interest Rate Restrictions in Developing and Emerging Market Economies

Interest rate restrictions in microfinance can be classified as direct interest rate controls, usury limits, or de facto controls. This typology has been defined by the Consultative Group to Assist the Poor (CGAP) as follows:

- **Interest rate controls** are imposed via banking, finance, or central bank laws that grant the regulator—usually, but not always in the case of microfinance, the central bank—the legal authority to fix the maximum lending interest rate for regulated financial institutions.3

- **Usury limits** are usually part of a civil code (or counterpart in common law legal systems) that authorize a government body to set a limit that private lenders may charge. They are aimed at private consumer lending; financial institutions governed by a banking law and regulated by the central bank are often excluded from it. Usury limits usually affect nongovernment organization (NGO) MFIs and, more directly, other lenders like pawn shops.

- **De facto controls** are formal interest rate ceilings that may not be codified into law, but political pressure or the need to compete with large, subsidized government lending programs keeps interest rates below a certain level. This definition can be expanded to include countries like Nepal, Pakistan, and the Philippines where MFIs are required to report their lending rates to the central bank (and to publish these in newspapers in Nepal), which is a process that exerts downward pressure on rates.

Some countries can have more than one type of control with large subsidized government programs playing the lead role but with interest rate controls and/or usury limits in place as well. Viet Nam and the People’s Republic of China are two examples of countries where subsidized lending by state-owned banks has led borrowers to expect subsidized loans, crowding out competition and limiting the availability of microfinance from other sources. For example, the Vietnam Bank for Social Policies lends extensively all over the country at just 6% per year. Table 2.1 lists countries found by CGAP in 2004 to have interest rate controls as defined by the typology above.

Though interest rate restrictions in microfinance are a hotly debated topic, systematic information on the actual restrictions prevailing in developing and emerging market countries is surprisingly sketchy. Perhaps partly because such a compilation can become dated rapidly, and due to frequent changes in such restrictions, there does not seem to be any systematic attempt to document them. The most recent information available on interest rate restrictions on microfinance in developing and emerging market economies is compiled in Table 2.2. In most countries, an effective rate in the range of 27%–30% appears to be the maximum acceptable, though ceiling rates in North Africa are significantly higher.

---

3 CGAP (2004).
Table 2.1: Types of Interest Rate Controls on Microfinance

<table>
<thead>
<tr>
<th>Interest Rate Controls</th>
<th>Usury Limits</th>
<th>De Facto Controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>Algeria</td>
<td>Armenia</td>
<td>Brazil</td>
</tr>
<tr>
<td>Bahamas</td>
<td>Bolvia</td>
<td>China, People’s Rep. of</td>
</tr>
<tr>
<td>China, People’s Rep. of</td>
<td>Brazil</td>
<td>Ethiopia</td>
</tr>
<tr>
<td>El Salvador</td>
<td>Chile</td>
<td>Lao PDR</td>
</tr>
<tr>
<td>India</td>
<td>Colombia</td>
<td>Nepal</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>Ecuador</td>
<td>Pakistan</td>
</tr>
<tr>
<td>Libya</td>
<td>Guatemala</td>
<td>Sri Lanka</td>
</tr>
<tr>
<td>Morocco</td>
<td>Honduras</td>
<td>Thailand</td>
</tr>
<tr>
<td>Myanmar</td>
<td>Kyrgyz Republic</td>
<td>Viet Nam</td>
</tr>
<tr>
<td>Philippines</td>
<td>Nicaragua</td>
<td></td>
</tr>
<tr>
<td>Paraguay</td>
<td>Philippines</td>
<td></td>
</tr>
<tr>
<td>Syria</td>
<td>South Africa</td>
<td></td>
</tr>
<tr>
<td>Turkey</td>
<td>Uruguay</td>
<td></td>
</tr>
<tr>
<td>Tunisia</td>
<td>Venezuela</td>
<td></td>
</tr>
<tr>
<td>UEAC (Central Africa)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>UMOA (West African Economic and Monetary Union)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zambia</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Lao PDR = Lao People’s Democratic Republic, UEAC (Central Africa) = Central African Economic and Monetary Community
UMOA (West Africa) = West African Monetary Union.

Table 2.2: Interest Rate Ceilings in Developing Countries

<table>
<thead>
<tr>
<th>Country or Grouping</th>
<th>Restrictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>North Africa (Morocco, Tunisia, Libya, Algeria, Egypt)</td>
<td>3%–5% per month</td>
</tr>
<tr>
<td>West Africa (member states of UMOA)</td>
<td>Limit of 27% on microloans</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>27% effective rate</td>
</tr>
<tr>
<td>China, People’s Rep. of</td>
<td>Four times the People’s Bank of China reference rate, which is currently 6.0%</td>
</tr>
<tr>
<td>India</td>
<td>Previously, 26% + 1% LPF; Currently, 12% margin cap + 1% LPF</td>
</tr>
<tr>
<td>Myanmar</td>
<td>2.5% per month</td>
</tr>
<tr>
<td>Bolivia, Brazil, Chile, Colombia, Guatemala, Ecuador, Nicaragua, Peru, Uruguay, Venezuela</td>
<td>Experimented with interest rate controls in the past decade</td>
</tr>
</tbody>
</table>

Source: Compiled from Miller (2013) and supplemented for Asia by the author.

2.2 Restrictions on Consumer Lending Rates in Developed Economies

Despite liberal reforms in financial markets over the past 3 decades, many developed economies still retain interest rate restrictions on small consumer lending. Table 2.3 lists the 14 European Union (EU) countries with interest rate restrictions. (The other 13 have none.)

Some of these countries have very complex systems with many categories depending on loan size and term, but restrictions are usually linked to the average APR calculated and specified by the central bank. More detailed information on restrictions on consumer lending rates in the five largest developed economies is presented in Table 2.4.
Table 2.3: Interest Rate Restrictions in the European Union

<table>
<thead>
<tr>
<th>Country</th>
<th>Scope</th>
<th>Restriction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>Non-bank credit only</td>
<td>6.75%</td>
</tr>
<tr>
<td>Ireland</td>
<td>Moneylenders</td>
<td>Max APR assigned annually, CUs 12.68%</td>
</tr>
<tr>
<td>Malta</td>
<td>Many exemptions</td>
<td>8%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country</th>
<th>Scope</th>
<th>Restriction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>All lenders</td>
<td>10.0%–19.5%, 12 categories</td>
</tr>
<tr>
<td>Estonia</td>
<td>All</td>
<td>3 times average APR, set monthly</td>
</tr>
<tr>
<td>France</td>
<td>All</td>
<td>see Table 2.4 below</td>
</tr>
<tr>
<td>Germany</td>
<td>All</td>
<td>see Table 2.4 below</td>
</tr>
<tr>
<td>Italy</td>
<td>All</td>
<td>Max APR = 150% average APR, max 27.2%</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>Not mortgages. Credit &lt;€ 200 (included)</td>
<td>Max = 12% + legal APR (5%, set every 6 months)</td>
</tr>
<tr>
<td>Poland</td>
<td>All</td>
<td>20%, 4 times Central Lombard Rate</td>
</tr>
<tr>
<td>Portugal</td>
<td>All</td>
<td>133% average APR, up to 31.6%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>All</td>
<td>2 times average APR, 30 categories</td>
</tr>
<tr>
<td>Slovenia</td>
<td>Non-bank credit only</td>
<td>2 times average APR; depends on term and amount</td>
</tr>
<tr>
<td>Spain</td>
<td>Overdraft, social housing loans</td>
<td>10%, 2.5 times legal interest rate</td>
</tr>
</tbody>
</table>

APR = annual percentage rate, CUs = credit unions.
Source: Reifner et al. (2010).

Table 2.4: Status of Interest Rate Restrictions on Consumer Lending in Major Developed Economies

<table>
<thead>
<tr>
<th>Country</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>Ceiling is 33% above average rate set by Banque de France</td>
</tr>
<tr>
<td></td>
<td>Rates for three categories of loans</td>
</tr>
<tr>
<td></td>
<td>Top rate peaked at 27.09% in 1993 (compulsory charges in APR, not insurance or collection charges on default)</td>
</tr>
<tr>
<td>Germany</td>
<td>No ceiling in credit law but court defined ceiling of 2 times average rates (maximum of 21.1% in 2006)</td>
</tr>
<tr>
<td></td>
<td>Compulsory charges in APR, not transactional or default collection charges, with emphasis on transparency</td>
</tr>
<tr>
<td>Japan</td>
<td>Maximum rate of 20% including all ancillary charges</td>
</tr>
<tr>
<td></td>
<td>Lending from single lender &gt; ¥500,000 or multiple lenders &gt; ¥1 million, must provide proof of financial means and all loans &lt; one-third of annual income</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>No ceilings subject to clear contracts, transparency, responsible lending practices</td>
</tr>
<tr>
<td>United States</td>
<td>6 states allow payday lending with no interest rate cap</td>
</tr>
<tr>
<td></td>
<td>31 states allow payday lending subject to a maximum rate over a 14-day period (in Oregon the period is 31 days)</td>
</tr>
<tr>
<td></td>
<td>12 states do not allow payday lending</td>
</tr>
<tr>
<td></td>
<td>2 states allow pawn-broking with no maximum rate</td>
</tr>
</tbody>
</table>

APR = annual percentage rate.
Of the five largest developed economies, only the United Kingdom (UK) has no rate restrictions. (Instead, the UK has transparency and responsible lending requirements). While a few states in the United States (US) have no restrictions, as many as 31 states limit payday lending to a 14-day period with a maximum percentage rate, two states only allow pawn-broking, and 10 states do not allow consumer or payday lending at all. The most restrictive country is Japan, which specifies a maximum lending rate, quantum restrictions, and responsible lending requirements related to the financial means of the borrower.

It is apparent that very few parts of the world have been able to avoid the lure of restricting interest rates in microfinance or small consumer finance. The following section examines the evidence on the impact of these restrictions on the availability, cost, and use of this type of finance.

3. THE IMPACT—REPRESSION AS FREEDOM

Restricting the interest rate (the price prevailing in a financial market) amounts to repressing the functioning of the market. A simple demand–supply analysis (Figure 2) is sufficient to see that with the prevailing supply curve $S_o$ (and demand curve $D$) the market interest rate is $r_o$. Restricting the interest rate to $r_t$ (under government or central bank fiat) will have the effect of reducing the supply of loans to $q_t$, which is well below the equilibrium level $q_o$.

![Figure 2: Demand–Supply Disequilibrium under Interest Rate Repression](image)

Source: In the context of this debate, there are numerous versions of this graph, including those used by Fernando (2006), Mohane et al. (2002), and Miller (2013). This graph is closest to Nimal Fernando’s formulation adapted and simplified from a graph in the World Development Report (1989).

Figure 2 forms the basis of the analysis of the effect of interest rate restrictions discussed in this section of the report.
3.1 Effect on the Demand for Microcredit

Various attempts have been made to assess the issues surrounding the determination of “appropriate” interest rate in microfinance. The most famous of these is the control trial conducted in three branches of SafeSave—an MFI in Bangladesh—in 2000–2001 by Dehejia, Montgomery, and Morduch. The results of the trial are best illustrated by the graph in Figure 3, which shows the monthly average loan balances for three branches covered by the trial. In two branches, Tikkapara and Kalyanpur (TIKA), the interest rate was increased from 2% to 3% per month in February 2000; in the third, Geneva (GE), the interest rate was set at 3% per month during the entire period under review.

Figure 3: Average Loan Balances at SafeSave Branches Before and After an Interest Rate Increase, 1999–2000

Source: Dehejia et al. (2005).

Figure 3 shows the parallel growth of average loan sizes in the two sets of branches before the change in interest rates for TIKA. After the change for TIKA, the average loan size for GE continued its steady growth, while the average loan size for TIKA seems to have hit a roadblock, remaining unchanged for around 10 months. The authors see this as an indication that customers are sensitive to interest rate changes; the stagnation in loan size after the interest rate increase suggests that some customers ceased borrowing while others limited their borrowings for a while. After an adjustment period, the loan balance started growing again as “only people able to pay the new prices were left,” according to the study report.

Based on statistical analysis, we calculate a range of interest rate elasticities from (-)0.73 to (-)1.04, with a preference for the higher-end of the range. In the context of this paper, our experiment suggests that the slope of the demand curve (D in Figure 2) between a market equilibrium rate \( r_o \) and a regulators’ preferred rate \( r_t \) could be quite significant, resulting in substantially increased demand \( (q_e) \) for microloans well above the market equilibrium supply level \( (q_o) \).

---

4 Dehejia et al. (2011).
Another randomized control trial with a consumer lender in South Africa produced apparently different but, in practice, consistent results with the one in Bangladesh. Karlan and Zinman’s study of the take-up of offers at various interest rates with APRs in the range of 50%–200% yielded “downward-sloping but relatively flat demand with respect to price.” Demand was more sensitive to loan maturity, particularly among lower-income borrowers. Thus, it is apparent that the size of the installment to be paid was more important as a determinant of demand than the price of the loan. These results are consistent with those of the Bangladesh study in that interest elasticities were found to be higher at the lower levels of interest charged in Bangladesh, indicating (as might be expected) that lower-income borrowers have higher price elasticities of demand. Thus, an interest rate ceiling is likely to increase demand for loans far more in a relatively low interest rate regime (Bangladesh) than a higher interest rate one (South Africa).

3.2 Effect on the Supply of Microcredit

On the other hand, looking at the supply curve $S_0$, it is apparent that if $r_t$ (the interest rate ceiling) is less than $r_o$, as in Figure 2, then supply will, in fact, shrink to the level $q_t$ up to which it is economical for MFIs and other consumer credit institutions catering to the low-income market to provide micro-loans. This shrinkage (or, more likely, lack of growth) will result from MFIs no longer working:

(i) in less accessible locations where operating expenses are likely to be higher;

(ii) with borrowers who have lower incomes and/or demand for loans of smaller sizes that have higher unit costs of loan processing and follow-up; and

(iii) with borrowers perceived to be more risky—such as the smallest borrowers, farmers in developing countries, and resident in troubled urban neighborhoods in developed economies—necessitating greater follow-up for recovery and higher provisioning for loan losses.

Interest rate ceilings can lead to two types of effects on microfinance: (i) market contraction and (ii) loss of transparency in pricing.

3.2.1 Market Contraction Resulting from Interest Rate Ceilings

CGAP (2004b) reviewed the evidence on these effects in some detail and found the following cases of market contraction resulting from interest rate ceilings:

- **Nicaragua.** When the national parliament introduced an interest rate ceiling in 2001 for specific types of lenders, including NGO MFIs, the annual portfolio growth of these MFIs fell from 30% to 2%, and some MFIs retreated from rural areas where operating expenses and risks were higher.

- **West Africa.** The Central Bank of West Africa’s (BCEAO) ceiling of 27% for non-bank lenders led to several large MFIs withdrawing from poorer, more remote communities to focus on urban areas where it is less expensive to operate. They also increased average loan sizes in order to lower average expenses and improve returns.

---

5 Karlan and Zinman (2008).
• **Colombia.** TACCION International research shows that interest rate ceilings repressed the development of commercial microfinance, mainly by discouraging NGO MFIs from transforming into licensed financial intermediaries.

• **Kenya.** The threat of an interest rate ceiling led to the Cooperative Bank of Kenya suspending its plans for a major expansion into the microfinance market.

A comparison of the market penetration rates in 23 developing countries with interest rate ceilings and seven countries without ceilings indicates higher market penetration rates in the latter. On average, those without interest rate ceilings applicable to microfinance had market penetration rates averaging 20.2%, while those with ceilings averaged just 4.6% (*Figure 4*). Morocco and Bolivia have significantly higher market penetration rates than their respective peers, which both have restrictive interest rate ceilings. Tunisia has large-scale state interventions in its financial markets in addition to a ceiling.

![Figure 4: Microfinance Market Penetration (With and Without Interest Rate Ceilings)](image)


Similarly, a review of consumer credit markets in developed countries by Policis (a UK-based independent consultancy) found a number of examples of lenders withdrawing from credit markets or reducing supply in response to tightening price controls. Japan is the most dramatic illustration of this; with the passing of an amendment to the Money Lending Business Control and Regulation Law in 2007, the regulatory regime for credit suppliers became much tighter. The ceiling rate was effectively reduced from 29.2% to 20.0%, and lenders were made responsible for ensuring that borrowers have annual incomes at least three times their total borrowing. The authors of the Policis report found “the impact of the tightening of the cap has been brutal for the industry with many players withdrawing from the market,” with effects on the amount of credit provided by the remaining players too (footnote 7). Lenders narrowed their risk pool so that higher-risk borrowers found it more difficult to get credit; the number of applications declined significantly due to reduced marketing; and, for those who did apply, approval rates declined from 63% to 36%. Over a period of 24 months, there was a

---

6 This analysis by CGAP used a proxy indicator for market penetration among the poor: the ratio of the number of microcredit loans to the number of people estimated to be living on less $2 per day.

7 Ellison and Forster (2008).
two-thirds reduction in borrowing from the consumer finance industry (Figures 5a and 5b). In 2008, it was expected that 50% of the 9.2 million users of consumer finance would be affected by the cap on individual lending that restricted borrowing to one-third of income.

Another example of lenders excluding high-risk borrowers as a result of stringent interest rate caps and minimum loan size comes from Germany. The Sparkassen mutual savings bank network was established with the social objective of acting as a counterweight to the relatively tight regulatory regime and interest rate ceiling in the German market. As Figures 6a and 6b show, less than 10% of lending by Sparkassen is to borrowers in the lowest-income quintile, with these borrowers also
“unlikely to have ready access to overdraft finance” (footnote 7). While the Sparkassen network is sometimes presented as an example of a lending institution that can offer credit to high-risk clients even under price controls, the authors of the Policis report point out that “the evidence would seem to indicate that (the Sparkassen network) stops some way short of inclusion” (footnote 7).
In those US states with greater regulation of consumer finance markets, the use of payday loans and sub-prime cash credit is much lower than in states with less regulation. Those with bank accounts are diverted to revolving credit from banks, while the unbanked (a significant minority among low-income households) must rely on pawn-brok ing. Although the total use of credit in states with ceilings is significantly below that of states without ceiling, total debt per head of those who can borrow is the same in states with and without ceilings. This provides a clear picture of the displacement of a significant number of high-risk borrowers (footnote 7).

3.2.2 Loss of Transparency and Consumer Sovereignty

Since interest rate stipulations (or laws) are often ambiguous on this matter, interest rate ceilings can also lead to a decline in transparency as micro-borrowers are not usually in a position to understand all the charges imposed on them or relate these to the overall cost of the loan. Especially when enforcement is weak or de facto controls exist through large-scale subsidized lending, MFIs may try to enhance their revenues beyond the ceiling by adding fees and commissions. Armenia and Nicaragua have had laws that were ambiguous about whether or not fees and commissions attached to loan products had to be included in the calculation of the interest rate. In South Africa, a Credit Law Review by the microfinance regulator found that some institutions had circumvented the cap by introducing credit life insurance and other charges linked to the loan. Similar practices have been prevalent in India in the aftermath of the crisis caused by the stringent microfinance law in the state of Andhra Pradesh.

There are also other ways of circumventing ambiguously designed caps. Changes in loan terms (4, 6, 12, 18, and 24 months) and varying periodicity of repayment (daily, weekly, monthly, bi-annual, and bullet) can create diverse changes in the effective interest rate, making it difficult to compare loan products and reducing transparency. In Myanmar, the Microfinance Law enacted in November 2011 includes no specification of the basis on which the 2.5% per month interest ceiling is to be calculated, leaving all aspects of the ceiling open to interpretation. With over 190 MFIs licensed by an enthusiastically liberal regulator, there are interesting times ahead in the development of the microfinance market in Myanmar. The loss of transparency resulting from interest rate ceilings and restrictions thus effectively limits consumer sovereignty (or the ability of borrowers to make informed choices).

In the case of consumer lending in developed markets, the issue of transparency in interest rates is equally complex. Reifner et al. (2010) document a number of issues that have arisen in European Union (EU) markets. These include the basis for the determination of contractual interest rates, charging of fees, and requirement for payment protection insurance (PPI). The rules on this vary across countries, with many countries adopting a fairly liberal approach.

The determination of the contractual interest rate when it is related to a variable rate is of particular concern since the average borrower may not be aware of the basis on which the interest rate comparator (such as LIBOR) may be fixed. As Table 2.3 above shows, 11 of the 14 EU countries with interest rate restrictions have ceiling rates that are relative to some type of bank rate. The ongoing scandal related to the determination of LIBOR adds to the concern that not only would the borrower not be aware of the basis for the determination of the bank rate, but also that the bank rate itself could be fixed by a cartel of bankers. (This concern is not specific to the issue of interest rate restrictions per se, but it applies to the normal determination of a contractual interest rate calculated on a relative basis.)
Table 3.1: Restrictions on Fees and Loan Insurance in the European Union

<table>
<thead>
<tr>
<th>Restrictions on:</th>
<th>Number of Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fees charged only</td>
<td>7</td>
</tr>
<tr>
<td>PPI only</td>
<td>6</td>
</tr>
<tr>
<td>Both</td>
<td>3</td>
</tr>
<tr>
<td>None</td>
<td>11</td>
</tr>
<tr>
<td>(of which IRR)</td>
<td>(4)</td>
</tr>
</tbody>
</table>

IIR = interest rate restrictions, PPI = payment protection insurance.

Source: Reifner et al. (2010), Table 20.

Restrictions on the charging of fees and requirements for payment protection insurance are also quite variable between EU member states. Only Poland has an absolute limit whereby charges additional to the contractual interest rate may not exceed 5% of the loan. Germany and Belgium also have fairness requirements on both fees charged and PPI. Another 13 countries have restrictions either on fees charged or PPI, while 11 countries have no restrictions at all. France, Greece, the Netherlands, and Spain have interest rate restrictions, but no restrictions on either fees or PPI. In the absence of restrictions on fees and insurance, the effect of interest rate restrictions is virtually nullified. As the authors of the EU study assert, “[a] price which omits important parts of the cost prevents a rational choice but also equal and just application of the [interest rate restriction].”

Thus, the repression of financial markets via interest rate restrictions and regulations may be a politically attractive choice, offering freedom from high interest rates for low-income families, but it is rarely an effective one. Not only does it result in the exclusion of the lowest-income, highest-risk segments of the community, those whom the politicians (and general public) most want to protect, it also promotes obfuscation and circumvention in financial pricing. The net result is reduced transparency in the market, and the consequent confusion in pricing results in loss of sovereignty for the consumer. To that extent, interest rate repression actually leads to a loss of financial freedom.

4. CONCLUSION—RECLAIMING THE WELFARE OBJECTIVE

The issue that interest rate restrictions attempt to address is one of social welfare: how to enable low-income families to obtain access to finance at a price that is acceptable to society. If the placing of restrictions on interest rates in microfinance is not the best means of enhancing social welfare by enabling low-income families to obtain finance at a reasonable price, then what is? The simplistic economist’s answer to this involves economies of scale, which can work in one of three ways. First, by increasing loan size it should be possible to bring down the average price of loans. Second, economic theory suggests that by expanding the amount of activity it should be possible to bring average costs down. Another way of reducing costs and/or squeezing the margin earned by MFIs and consumer finance organizations would be to promote competition.

In the context of the analytical framework presented in Figure 2 above, this entails shifting the supply curve \( S_o \) to position \( S_e \), implying lower operating expenses and, therefore, supply \( q_e \) at the socially acceptable rate of interest \( r_t \). This could expand the supply of small finance to low-income families to a level \( (q_e) \) that is higher than the original equilibrium supply \( q_o \), which would be a socially optimal

---

8 Reifner et al. (2010), p. 94.
outcome. The further the supply curve $S_o$ can be shifted to the right, the better it is for social welfare. Let us look at each of these possibilities in turn.

### 4.1 Economies of Scale

As the discussion in the previous section has shown, wherever possible, MFIs or consumer finance organizations move to larger loan sizes or areas that are easier to work in. This amounts to a move up-market in that it leaves the poorest sections of the population seeking the smallest loan sizes underserved. Clearly, increasing loan size is not the best means of addressing the welfare issue that interest rate restrictions are used for.

Expanding economic activity, essentially means expanding the size of the economic unit whether it is an organization or, in this case, MFIs and consumer finance agencies. In theory, a single organization undertaking economic activity on a larger scale should be able to bring down the cost of production or service provision by spreading fixed costs over larger volumes of output. In microfinance, however, economies of scale are a chimera. MFIs attempt to deliver services at the doorstep (i.e., in the neighborhood) of the client. In practice this means that the cost of computer software (and bulk purchase discounts for hardware) can be spread over larger numbers as can the cost of negotiations with banks and investors for bulk funding, the cost of independent assessments, and other head office expenses. However, doorstep services mean a large number of branches and even a larger number of staff. While some organizations have attempted to push staff productivity to substantial numbers (at one point, the largest MFIs in India averaged over 600 client accounts per loan officer), this has had its own negative repercussions. While a few of the largest MFIs in other countries in Asia with relatively large microfinance sectors—such as Bangladesh, Cambodia, Nepal, Pakistan, and the Philippines—have client-to-loan-officer ratios in the 400–500 range, there is some evidence of over-heating at this level of productivity and each of these countries has experienced low-level crises in microfinance during the past few years as a result. Thus, it appears around 400 clients per loan officer is effectively the upper limit for manageable loan officer productivity in Asian microfinance.

**Figure 7** shows that microfinance in India was able collectively to reduce its operating expense ratio from over 13% in 2006 to below 8%–9% by 2010–2011 (before the onset of the crisis in the state of Andhra Pradesh upset the whole operation).

However, this improvement, as argued by the author in another paper, can be attributed to the achievement of economies of scale as well as the over-simplification of the relationship between MFIs and clients. As a result, time spent on group formation or group development processes is much less. In the late 1990s, a self-help group, to become eligible for an MFI loan was expected to be in existence for a minimum of 6 months. To get eligible for an MFI loan even a joint liability group (Grameen-type solidarity) was required to meet regularly for a minimum of 8 weeks and members were not allowed to have a loan from any other source.\(^9\)

---

However, around 2007 when the race for growth (and achieving economies of scale) became the norm, MFI loan officers bypassed the group processes and single-source lending. A situation arose where an MFI loan officer, in the extreme, preferred to wait outside a group meeting organized by another MFI to offer the same group another loan or to collect from that group (whose clients were enrolled by him previously). It was a win-win situation for both MFIs and clients in the short-term. The MFI loan officer could meet his targets quickly while the MFI could maximize its growth. The client had access to larger sums of money in relatively short periods of time to meet her investment (or consumption) needs, irrespective of whether she was in a position to repay. One Indian MFI client in Kolar (Karnataka) mentioned to the author: “Would you not take money if someone offered it to you with little paperwork and no collateral? (footnote 9)"

While the situation was not as stark in other countries—except in the case of one MFI in Pakistan—there was a tendency for similar situations to develop in Bangladesh, Cambodia, and Nepal, as well as some places in the Philippines (e.g., urban Manila and parts of Luzon and northern Mindanao), before better sense prevailed and some of the leading organizations either consciously scaled back (Bangladesh) or moderated their growth (Cambodia, Nepal, the Philippines). Since people (as loan officers and other staff) are the capital that generates revenue (as output) at MFIs, the limits to achieving economies of scale are set by human failings and are not amenable to simple considerations of size of operations.

**Maintaining portfolio quality.** The MFIs were of the view that as long as overall loan delinquency was within 1%–2% of the overall portfolio, in a high-growth situation they could keep on growing. In South Asia, commercial banks in their capacity as lenders and providers of funds to MFIs, and elsewhere apex agencies (the Philippines) and international investors (Cambodia), also bought into this line of thinking. They all forgot the first lesson of microfinance performance: large recent disbursements mask portfolio quality ratios because the denominator of the ratio (total portfolio) grows faster than the numerator (quantum of bad loans). M-CRIL (a specialized microfinance rating agency), carried out loan portfolio audits of some of the largest MFIs at the branch level and found estimated profits-at-risk (PAR) of 5%–7%. At that time, the same MFIs in their transparency reporting to the Microfinance
Information Exchange (MIX) reported PAR of less than 0.5%. It is evident that with the expansion of operations of large MFIs at a hectic pace, their internal control systems were unable to keep pace. The practice of refinancing distressed borrowers became increasingly widespread among branch managers who were anxious to maintain their portfolio levels to maximize incentive payments. Nobody considered the possibility of clients getting deeper and deeper into trouble. The previous adverse experience of the Grameen Bank of Bangladesh which the large Indian MFIs ignored by arguing that they had cultivated a “professional” work culture compared to Grameen Bank's “social” culture did not hold good (footnote 9).

**Multiple lending in well-served areas.** According to M-CRIL estimates, multiple lending practices resulted in around a 40% overlap in India, 30% in Cambodia, and 20% in Bangladesh and Nepal. Most of them were in clusters that were easy-to-reach with established microfinance operations. In some of the more microfinance-oriented Indian states like Andhra Pradesh, Tamil Nadu, and West Bengal these overlaps exceeded 200%. The problem was so acute in some places that borrowers were reported hopping from one meeting to another and/or spending as much as 2.5 hours per weekday at meetings. In these meetings, the only business was making repayments, completing loan applications, and receiving repayments. Similar, conditions were reported in the Tangail district of Bangladesh. By following an effectively reductionist approach, the relationship between the MFI and the client became one that is akin to retailing. In the rush for growth and economies of scale, the development objectives of the MFI group meetings of the 1990s were abandoned. It is this cutting of corners that formed the background to many microfinance crises (footnote 10).

It is apparent that the quest for economies of scale (and profits) resulted in reducing the OER in some countries to well below a reasonable level; this is a quest that can be taken up to a certain point in microfinance but no further. One should not be surprised that Figure 7 shows a sharp rise in the OER after the onset of the crisis in India in 2010 as a result of the introduction of more careful intermediation and debt recovery processes. Similarly, the OER increased significantly in the Philippines over the past few years and has shown a tendency to rise in Nepal over the past couple of years.

### 4.2 Competition

It has been argued by CGAP, among others, that competition can help bring down the cost of microfinance to low-income clients. Evidence from a number of countries supports this argument. The most well-known case is that of Bolivia where MFI interest rates are observed to have dropped from around 60% in 1992 to just 17% in 2007, a decline of 43%. During the same period, bank rates dropped by just 12 percentage points (Figure 8).

CGAP analysis of interest yields between 2003 and 2006, as reported to MIX by 175 MFIs worldwide, showed that (apart from South Asia) yields were dropping by 2.3% per year over that period.

---


11 CGAP (2009).
The paper also presents data and studies from a number of other competitive microfinance markets—such as Bolivia, Bosnia, Mexico, Morocco, Peru, and Cambodia—indicating significant to moderate declines in interest rates. However, given the well-known study of the effect of competition on interest rates in Bangladesh, Bolivia, Uganda, which did not find any decline in interest rates in either Uganda or Bangladesh, the authors are cautious about attributing these declines (across a range of countries) specifically to growing competition. Indeed, it is apparent from Figure 7 that there was actually an increase in interest yields in India even as competition grew substantially throughout the late 2000s. Since most microfinance markets are still in a consolidation phase, these anomalies could be attributed to short-term phenomena, but it is apparent from the case of India that, contrary to expectations, competition can also have harmful effects on client welfare, at least in the short- to medium-term.

### 4.3 Can the Welfare Objective be Reclaimed?

How to reclaim the objective of maximizing the welfare of the low-income borrowers of MFIs or consumer finance institutions (in developed countries) is a vexing question. While both economies of scale (to reduce expenses) and competitive pressures to reduce inefficiencies and profitability can play a role, in many markets these solutions either may not be enough, or perhaps not remedy the situation quickly enough, to satisfy the critics. As discussed above, it can take a long time for competition to reach the stage where it becomes effective in forcing efficiency and influencing price. What else can be done short of using interest rate restrictions, and thereby excluding the most vulnerable from access to finance, is an important question.

---

13 By Eric Duflos of CGAP.
15 See, Karnani (2009) for a strong condemnation of MFI practices and a strident call for restrictions on interest rates in addition to consumer protection regulation to ensure transparency and humane loan recovery practices.
The theory of fair interest rates in microcredit has been discussed in some detail in a CEB working paper. Is it always fair that the most vulnerable sections of society should bear the full cost of the services provided to them? The liberal democratic principle of progressive taxation to provide welfare to the deprived clearly does not require the poor to bear the full cost of their basic necessities; is not access to finance then also a basic necessity? If so, how can access to finance be enhanced? A few possibilities are listed below

- **A dramatic shift to the right of the supply curve** $S_e$ **in Figure 2** through a major technological (or managerial) breakthrough that very substantially reduces the cost of outreach to remote areas (through mobile technology) and/or reduces the cost of intermediation (through comprehensive and verifiable databases on low-income families and their income-earning capacities). While there has been significant progress in this direction in recent years, the hardware maintenance and data generation challenges are substantial, and the goal may still be a long way off. The high investment cost of new technologies, compounded by the infrastructure bottlenecks in developing countries, add to the distance of this goal.

- **An artificial shift to the right of the supply curve via a reduction in expenses resulting from the substantial availability of low-cost credit lines to MFIs.** This can be (and has been) done by governments with the revenues from progressive taxation through development banks and apex agencies. However, there is concern that such subsidies may be subsumed by inefficiencies in MFI operations and the availability of the subsidy may, in itself, reduce the incentive to improve efficiency. Some have even pointed to a crowding-out effect in which the apex agency finds it easier to finance large MFIs to the exclusion of the smaller ones more likely to reach the most vulnerable. Vigilance by the apex agency becomes critical and often creates a demand for an interest rate ceiling (as in Bangladesh through PKSF) that may or may not be appropriate.

- **Guarantees that share the default risk in working with the most vulnerable to help reduce the cost of credit to the latter.** Here too, vigilance is needed to limit the effects of moral hazard that could be the result of careless intermediation by the MFI lulled into complacency by the guarantee. A specific example of this is the experience of the government-financed Agricultural Credit Guarantee Scheme Fund of Nigeria, which reported a 52.9% cumulative repayment rate in 2009. The fund manager, the central bank, reported that the single factor constraining the repayment of loans under the system was the bad loans granted in its early years (1978–1988), with significant improvement in its loan appraisal and monitoring procedures since then. However, the repayment rate in 2009 was lower than the 58.5% rate reported in 2007, suggesting that the performance of the portfolio continued to decline.

Ultimately, as Hudon and Sandberg have argued (footnote 16), what is needed is a mix of the consequentialist approach that maximizes overall utility—through a balance of efficiency, transparency, subsidy, sustainability—and a concern for justice that recognizes the rights of the poor to finance as a necessity. Multilateral development banks and other donors have already played a role here by supporting the development of more amenable regulatory and supervisory structures and disseminating information on good microfinance practice in different countries. Supporting pro-competitive policies and cost reduction strategies by subsidizing product development and technical innovation in areas such as mobile banking and micro-insurance, together with their replication or

---

16 Hudon and Sandberg (2011).
adaptation across countries, and promoting transparency and consumer protection could also be accelerated.

Essentially, every effort should be made to ensure that finance actually reaches the poor and that the service provider is efficient in its operations and humane in its approach. While interest rate restrictions alone can have significantly negative consequences, used knowledgeably in a judicious blend with a series of the measures described here they could also facilitate the goal of providing low-income families with access to finance in an environment of fairness and justice.

Overall, in the past few years, the world of microfinance has moved significantly in this direction. Efficiency, transparency, and sustainability have become a well-established mantra of microfinance with many of the best MFIs in Asia and elsewhere in the developing world striving to fulfil these objectives to the extent possible. The development of social rating frameworks along with financial rating by specialized microfinance rating agencies, the work of the Smart Campaign to ensure fairness to clients, and the work of Truelift to emphasize relevance to the needs of the poor are important steps in this direction and have come to be accepted to varying degrees. Where there is still some disconnect is that subsidies and interest rate restrictions are designed by politicians and bureaucrats with little knowledge or understanding of microfinance. Such measures are based on political and populist considerations rather than a real understanding of their impact in practice.

A better and more widely shared understanding of the drivers of interest rates in various financial markets, including microfinance, is needed to inform policy dialogues and improve the design of development projects that aim to enhance the internal efficiency of MFIs and promote competition that lowers interest rate spreads. In addition, there needs to be greater understanding of the effects of government policy on market interest rates: when governments run large public deficits, high average rates of interest in the domestic financial market affect the cost of funds for financial intermediaries. Similarly, if the domestic currency depreciates or is devalued, microfinance operators that have borrowed abroad may be forced to raise their interest rates due to the increased cost of foreign debt.

The goal must be to bring these sets of measures together so that decisions by governments and regulators are taken in a knowledgeable environment and in cooperation with agencies with an understanding of microfinance (e.g., CGAP, multilateral development banks, and microfinance rating and research agencies). However, governments tend to be suspicious of their motives, even of apparently impartial and well-respected microfinance research agencies, so multilateral development banks need to play a much more active role in bridging the gap in understanding. The distance to the goal of universal financial inclusion needs to be considerably shortened from the long road it appears to be in the current policy environment.
REFERENCES


Gonzalez-Vega, C. and Villafani-Ibarneagaray. 2007. Las Mikrofinanzas en la Profundizcion del Sistema Financiero. El Caso de Bolivia El Trimestre Economico. 74 (293).


Miller, H. 2013. Interest rate caps and their impact on financial inclusion. EPS-PEAKS.


Protitch, M. 2007. The role of Interest rate in microfinance: Why they are so high and how they affect consumer behaviour. Berlin: Humboldt University.


Impact of Restrictions on Interest Rates in Microfinance

The paper examines the impact of restrictions on interest rates in microfinance. The issue that interest rate restrictions attempt to address is one of social welfare: how to enable low-income families to obtain access to finance at a price that is acceptable to society. If imposing of restrictions on interest rates in microfinance is not the best means of enhancing social welfare for enabling low-income families to obtain finance at a reasonable price, then what is? The simplistic economist’s answer to this involves economies of scale, which can work in one of three ways. First, by increasing loan size it should be possible to bring down the average price of loans. Second, economic theory suggests that by expanding the amount of activity it should be possible to bring average costs down. And finally, promoting competition is another way of reducing costs and/or squeezing the margin earned by microfinance institutions.

About the Asian Development Bank

ADB’s vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region’s many successes, it remains home to half of the world’s extreme poor. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.