

Understanding and Dealing with High Interest Rates on Microcredit

A Note to Policy Makers
in the Asia and Pacific Region

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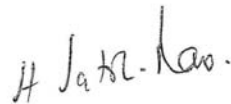
Nimal A. Fernando is Principal Microfinance Specialist in the East Asia Department of the Asian Development Bank (ADB).

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Foreword

Microfinance is widely recognized as an effective tool for poverty reduction. This recognition has persuaded the development community to support the industry's growth in a variety of ways.

This paper deals with an important subject in microfinance. The Asian Development Bank hopes that the paper will help policy makers gain a deeper understanding of the issues surrounding microcredit interest rates. This understanding will hopefully further enable them to pursue measures that would ensure both the continued growth of the microfinance industry and the enhanced access of poor people to affordable microcredit.



Satish H. Rao
Director General
East Asia Department
Asian Development Bank

Introduction¹

Policy makers in Asia and the Pacific are increasingly critical of the high interest rates that microfinance institutions (MFIs) charge. Some policy makers have suggested that ceilings be introduced on microcredit interest rates to ensure that poor households have access to affordable credit.

Charging prices high enough to cover costs is an essential practice for any business enterprise that intends to continue its operations beyond the short-term. Thus, it is not surprising that promoters of sustainable microfinance have emphasized the need to adopt this practice by MFIs. Many MFIs in the region have thus adopted cost recovery interest rates on microcredit. A significant number of such institutions have been able to expand the depth and breadth of their operations.

The nominal interest rates charged by most MFIs in the region range from 30% to 70% a year (on a reducing-balance basis). The effective interest rates are even higher because of commissions and fees charged by MFIs. Other factors-such as the compulsory deposits for obtaining a loan, frequency of repayments, and the systems adopted to collect repayments-also raise the effective interest rates.

High interest rates charged by MFIs have attracted criticism from government and opposition leaders in Bangladesh, Cambodia, India, Pakistan, and Sri Lanka. At a microcredit summit in Dhaka in 2004, the Minister of Finance for Bangladesh described microcredit interest rates in that country as "extortionate." The Prime Minister of Cambodia has asked lending agencies to consider reducing microcredit interest rates. The Chief Minister of the Andhra Pradesh government in India recently suggested that MFIs offer loans at 3% per year to members of self-help groups. Concerns about high interest rates have

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¹ The author gratefully acknowledges the comments of Heather Clark on an earlier version of this paper.

also been expressed in other states in India. The Government of Sri Lanka recently introduced interest rate ceilings on a number of microcredit schemes operated through the National Development Trust Fund, the government-controlled apex agency in the industry.

Why Microcredit Rates are So High

An MFI's main objective is to provide poor and low-income households with an affordable source of financial services. Interest charged on loans is the main source of income for these institutions and, because they incur huge costs, the rates are correspondingly high. Four key factors determine these rates: the cost of funds, the MFI's operating expenses, loan losses, and profits needed to expand their capital base and fund expected future growth.

Many policy makers question why microfinance interest rates remain high even when MFIs receive concessional funds to finance lending. Although microlenders receive loan funds at concessional rates, they must cost these funds at market rates when they make decisions about interest rates to ensure the sustainability of the institution's operations. Donors provide concessional funds for a particular usage only for a limited period, as do some governments. However, concessional funds cannot be considered a permanent source of funds for MFIs, and provision must be made through interest rates to sustain the lenders' operations.

Inflation adds to the cost of microfinance funds by eroding microlenders' equity. Thus, higher inflation rates contribute to higher nominal microcredit interest rates through their effect on the real value of equity.

Microlenders have two kinds of operating costs: personnel and administrative. Because microlending is still a labor-intensive operation, personnel costs are high.

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Administrative costs consist mainly of rent, utility charges, transport, office supplies, and depreciation of fixed assets. Making and recovering small loans is costly on a per unit basis. Often loan recovery is executed by staff who visit clients, increasing costs in time taken and transportation used. Poor physical infrastructure—inadequate road networks, transportation, and telecommunication systems—in many countries in which microlenders operate also increases administrative costs and adds significantly to the cost of microfinance operations. This is particularly the case in Timor-Leste, Cambodia, Mongolia, and some states in India. Inadequate law and order—particularly in countries such as Nepal and Papua New Guinea, and the state of Bihar in India—also contribute to high administrative costs as microcredit operations often involve cash transactions and the physical movement of cash.

In many countries in the region, the majority of microcredit is provided by a few leading institutions, and competition among them is mostly on non-price terms. Large-scale commercial banks with access to low-cost funds, low operating costs, extensive branch networks, and vast human and other resources to provide financial services efficiently are presently not significantly involved in microcredit. The lack of participation of such conventional financial institutions in the microcredit market also limits potential competition.

Inappropriate Comparisons

Microcredit interest rates are often compared with those charged by both commercial banks and excessively subsidized lending organizations. Such comparisons are inappropriate. Commercial banks most often deal with large loans, and their transaction costs are lower than those of MFIs on a per unit basis. Thus, commercial banks are able to charge lower interest rates than MFIs. A

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financial institution receiving large subsidies may charge much lower interest rates than other MFIs. In Bangladesh, the Grameen Bank charges an annual interest rate of 20% (on a reducing-balance basis) on its main credit product. Because this rate was below cost recovery levels, the Grameen Bank incurred losses for many years, and these losses were underwritten by the big subsidies it received. Thus, Grameen Bank's interest rates should not be compared with those of an MFI that has not received similar subsidies.

Other inappropriate comparisons of MFI interest rates include those charged by government-owned MFIs or government-sponsored microfinance programs that are often compelled to charge lower-than-cost-recovery interest rates based on political considerations. These comparisons also overlook that most of these programs and institutions in general are unlikely to survive in the long term to serve the poor. Moreover, the poor have to incur unusually high transaction costs to access credit from these sources due to credit rationing systems and rent-seeking practices adopted by their employees. Thus, a comparison based on nominal interest rates charged by such institutions may be highly misleading.

Lenders will incur losses if a rate ceiling is set at a level less than that required for cost recovery

Rate Ceilings: Not The Answer

Lower microcredit interest rates will help increase the depth and breadth of availability of affordable finance for poor households. Imposing ceilings on microcredit interest rates is not the answer.

Lenders will incur losses if a rate ceiling is set at a level less than that required for cost recovery, reducing an MFI's willingness and ability to expand operations, and discouraging potential investors from supporting the industry. Rate ceilings will reduce the creditworthiness of MFIs, reducing their ability to borrow from the market to

finance their operations, and prompting a decline in the supply of credit, contrary to expectations of policy makers who seek such a ceiling. Because small-scale loans are more expensive than large loans, rate ceilings could encourage microcredit lenders to desert poorer, small-scale loan clients. Rate ceilings would change the nature of MFI lending, creating a shift to more short-term loans. As a rate ceiling would increase policy risk, and if inflation were expected to rise, longer-term loans would carry greater risks. Rate ceilings would create an artificially high demand for microcredit relative to supply and encourage credit officers and others to adopt rationing devices that, in turn, create rent-seeking opportunities. If a rate ceiling is imposed on a state-owned institution, government will have to provide funds to cover the resulting losses.

If lenders mobilize deposits, microcredit interest rate ceilings may compel them to lower their deposit rates, adversely affecting savers. Because ceilings depress the profitability and viability of MFIs, savers may be reluctant to place deposits in them. This aggravates the institutions' funding problems while curtailing a valuable service in demand from poor clients and source of domestic investment. The potential impact of ceilings on microcredit interest rates is shown in Figure 1.

Evidence From the Region

Empirical evidence in the Asia and Pacific region strongly supports the view that liberal interest rate policies fuel the growth of the microfinance industry. More than 50 million poor people now have access to microcredit from formal and semi-formal institutions in the region.

In Bangladesh, more than 10 million poor people—mostly women—borrow from a range of MFIs. The Grameen Bank, BRAC, and the Association for Social Advancement each serve more than 3 million borrowers

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Figure 1. General Impact of Ceilings on Microcredit Interest Rates

The Supply Side	The Demand Side
<p>Short-Term</p> <ul style="list-style-type: none"> • Lenders compelled to reduce their rates; • Excess demand creates incentives for rent-seeking among lending staff; • Viability of lending to the poor reduced; • Lenders' profits on loans to the poor reduced; • Incentives to make loans to the poor reduced; • Incentives to increase investments to expand loans to the poor reduced; • Policy risk on lending to the poor increased (threat of new ceilings); • A negative signal sent to potential investors; • Risk of lending to microlenders increased; • Incentives to commercial banks to enter the microcredit market reduced. 	<p>Short-Term</p> <ul style="list-style-type: none"> • Demand for loans increases at the ceiling rate; • Some new potential clients seek loans at the new rates; • An excess demand for loans created at the ceiling rate; • Price of credit to some of those who actually get loans reduced; • Some borrowers pay higher transaction costs than before.
<p>Medium- to Long-Term</p> <ul style="list-style-type: none"> • Microlenders' creditworthiness declines; • Price at which microlenders can borrow in the market increases; • Microlenders' profit declines; • Supply of funds from some donors declines; • Some lenders leave the market; • Supply of loans to the poor decline; • Microlenders' quality of services to the poor declines; • Interest rates paid on deposits reduced by affected microlenders; • Microlenders increase transaction costs of small deposits; • Supply of microlenders' other financial services to the poor also declines. 	<p>Medium- to Long-Term</p> <ul style="list-style-type: none"> • Some borrowers shift to informal commercial markets; • Many former borrowers become worse off by the decline in supply; • Defaults increase.

annually. MFIs in India, such as SKS Ltd, have expanded their outreach to poor households. In Cambodia, more than 500,000 poor people borrow from MFIs. ACLEDA Bank, the leading provider of financial services for the poor in Cambodia, serves more than 140,000 borrowers and many savers from low-income groups. Bank Rakyat Indonesia continues to serve millions of borrowers and savers from poor and low-income households. Mongolia's Xaan Bank and Xac Bank have expanded their outreach remarkably during the past 5 years.

The increase in outreach is occurring in environments where lending institutions are free to set interest rates based on their own institutional factors and market characteristics. In countries where interest rate ceilings have been a major characteristic of the market, such as Viet Nam and the People's Republic of China, growth of outreach has been disappointingly low, despite massive subsidies in providing credit to the poor. Often those institutions receiving subsidies have become financially fragile and severely dependent on subsidies to continue their operations.

The Case for Low Interest Rates

While high microcredit interest rates have helped the industry grow, and enabled many millions of poor and low-income households to gain access to credit, there are still those who cannot afford such loans because of their high cost. Microcredit has not reached a majority of the poorest people and is not widely used for financing farming activities. Only those who can generate a sufficiently high surplus of funds can afford high interest rates on microcredit. More specifically, a borrower's realized rate of return on investment needs to be greater than the interest rate to service the loan. Such enterprises with potentially very high margins exist in the region and

In countries where interest rate ceilings have been a major characteristic of the market, growth of outreach has been disappointingly low

typically include petty trading, small-scale restaurants, bakeries, and micro-livestock activities, including backyard poultry raising.

In a typical developing economy, the best available investment opportunities for a majority of poor households involve those with moderate returns. Households in this category cannot be expected to have the same ability to service loans taken at high interest rates as those who realize high returns on their investments. Also, poor households need credit to meet expenditures on health, education and many life-cycle events. Thus, it is important to make a concerted effort to lower interest rates on microcredit. However, this must be achieved through promoting more competitive markets, low-cost operations, and efficiency of MFIs rather than through government-led administrative measures that undermine sustainable development of the industry.

What Can Policy Makers Do?

Policy makers can resist requests to impose rate ceilings that will retard the growth of the MFI industry and result in reducing the supply of microcredit and other financial services, harming rather than helping poor and low-income households. A hands-off approach on interest rates may seem politically unpalatable, but the politically palatable action of ceilings does not address the root causes of high interest rates and will exacerbate the problem. However, a hands-off approach on interest rates does not suggest a do-nothing approach for the policy makers.

Policy makers must be proactive in seeking measures to reduce microcredit interest rates in a sustainable manner, including promoting an enabling environment for MFIs, encouraging the entry of different kinds of institutions into the industry, and laying the foundations for

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more competitive markets. Some of these initiatives include developing the physical, human, and financial infrastructure and controlling inflation.

Uncertainty about public policy on microcredit interest rates has a negative effect on the supply of microcredit. A clear policy statement from governments assuring that interest-rate ceilings on microcredit will not be imposed would eliminate a significant policy risk and encourage existing institutions to increase investments, and new institutions to enter the market, improving the potential for greater market competition. Policy makers can create a liberal environment for international commercial and social investors to make equity investments in local MFIs. In addition, central banks can encourage in-depth research on microfinance markets to identify constraints on their sustainable growth and share findings with policy makers and politicians at the central, state, and provincial government levels. The central banks also need to inform the policy makers of potentially severe adverse consequences of microcredit interest rate ceilings. Such measures will help ensure improvements in the microfinance industry in the medium to long term.

Some countries in the region are already showing encouraging results from their efforts to create a more competitive environment for the microfinance industry. Cambodia has allowed national and international nongovernmental organizations (NGOs) to operate freely in the market, helping them increase their outreach. A legal framework was created for licensing NGO MFIs and helping them transform into regulated financial institutions to offer poor households a wide range of services. Policy makers opted for a truth in lending law rather than impose an interest rate ceiling. Together, these measures have resulted in a more competitive industry that, in turn, has led to lower microcredit interest rates. Microcredit interest rates in the country have declined from around

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10% per month (on a reducing-balance basis) to 3-4% per month (on the same basis) during the last 5 years. The market leader, ACLEDA Bank, has reduced its rates significantly during this period.

Mongolia's liberal policies are also encouraging similar developments to those in Cambodia. Xac Bank's weighted average interest rate on microcredit declined from 39% per year to 35.8% per year (on reducing-balance basis) in December 2003.

Improving the Physical and Human Infrastructure

Simple infrastructure improvements—such as road links, bridges, and the reliable supply of electricity—and better human infrastructure will have a positive impact on the operating costs of microlenders. Such improvements also expand economic opportunities for poor households. Indonesia made large investments in rural infrastructure—public schools, public health centers, and irrigation networks—in the 1970s and early 1980s and these have helped increase the growth of its microfinance industry from the mid-1980s. Had there been no such investment in rural areas, microfinance industry growth in Indonesia would have been more difficult and the operating costs of microlenders much higher. Governments should seek consultation with MFIs to understand better the infrastructure bottlenecks they face that thwart their activities, and endeavor to improve such infrastructure. Policy makers also need to pay attention to improving infrastructure that specifically affects the use of new information and communication technology by MFIs, given that such technology can have a potentially significant positive impact on lenders' operating costs. Human infrastructure improvements, particularly in primary and adult education and accounting and auditing will also have a significant

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bearing on operating costs. For example, better-educated clients reduce costs to the MFIs. Thus, policy makers need to help develop financial literacy among the poor and low-income households.

Policy makers also need to understand better the significance of, and the vital need to, reduce lenders' operating costs because high operating costs is a root cause of the high interest rates on microcredit. Separating fundamental causes from proximate causes of high interest rates is critically important for designing appropriate interventions.

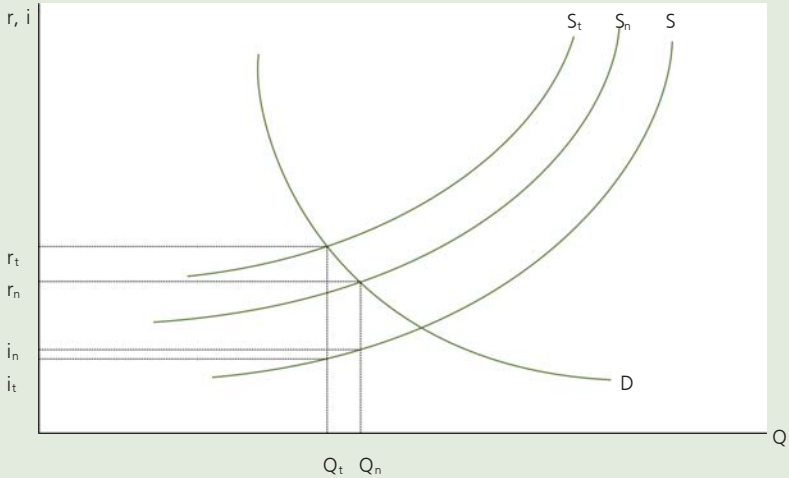
Operating costs result in a wedge between the interest rate borrowers pay and the return lenders receive. Reduced operating costs increases lenders' returns and the quantity of loans supplied. On the demand side, reduced operating costs will lead to a fall in the interest rate that borrowers pay and an increase in the quantity of borrowing (see Figure 2). A decline in interest rate brought about in this manner is a "win-win-win" proposition: it is beneficial for both lenders and borrowers, will reinforce rather than undermine the development of microcredit services, and will help policy makers achieve their objective of ensuring access to credit for the poor at affordable prices.

Recognizing Innovation and Efficiency

MFIs must find innovative ways to improve their productivity and efficiency, and reduce operating costs. Essential to this process is cost-reducing innovations. Governments in the region can help facilitate innovation in the microfinance industry by recognizing and rewarding innovators, thereby encouraging further innovation. Similarly, governments can help ensure that information on more efficient MFIs is disseminated widely.

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Figure 2. Impact of Operating Costs on the Supply of and Demand for Microcredit



KEY

Horizontal axis measures the quantity of lending or borrowing per unit of time. Vertical axis measures the interest rate (r) borrowers pay and gross return (i) lenders receive.

The economy's demand for microcredit is shown by the demand curve, D .

The industry's supply of microcredit, if there were no lender operating costs, is shown by the supply curve S .

S_t is the industry's supply curve of microcredit with operating costs.

- At this initial level of operating costs, borrowers pay an interest rate of r_t .
- And the lenders' gross return after deducting operating costs is i_t .
- The quantity borrowed (lent) is Q_t .
- Now assume that lender operating costs are reduced through some innovations and improvements in financial infrastructure. And this shifts the supply curve to S_n .
- Now the amount of microcredit lent (the amount of microcredit borrowed) increases from Q_t to Q_n and the gross return to lenders increases from i_t to i_n .
- And the interest rate to borrowers declines from r_t to r_n .

Source: Adapted and simplified from the World Bank.1989. *The World Development Report* 1989. Washington DC: The World Bank. 30.

The Way Forward

Microcredit interest rates are high because microlending remains a high-cost operation. The key to reducing these rates in a sustainable manner is to reduce costs through improved market competition, innovation, and efficiency. Interest rate ceilings are not an appropriate intervention, and there are no quick solutions or shortcuts. As has been shown already in some countries in the region, there are solutions for the medium to long term. To provide affordable finance to poor households in Asia and the Pacific, policy makers need to recognize, and rectify impediments such as lack of physical, human, and financial infrastructure, promote competition and efficiency, and be proactive in providing an enabling environment for MFIs to develop in a sustainable manner.

Interest rate ceilings are not an appropriate intervention, and there are no quick solutions or shortcuts

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Understanding and Dealing with High Interest Rates on Microcredit

Charging prices high enough to cover costs is essential for any business to survive in the marketplace. This is true for institutions providing microfinance services as it is for any other enterprise. Thus, it is not surprising that many successful microfinance institutions charge high interest rates to cover their high costs. However, despite the success of those institutions in expanding the supply of credit during the last 2 decades to an increasing number of poor and low-income households, some countries in the region seem to be moving to impose ceilings on microcredit interest rates. This paper discusses why such moves are likely to hurt the poor. And the paper points toward a number of positive measures that policy makers could consider to bring down the high microcredit interest rates without hurting the industry and its clients.

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The work of the Asian Development Bank (ADB) is aimed at improving the welfare of the people in Asia and the Pacific, particularly the nearly 1.9 billion who live on less than \$2 a day. Despite many success stories, Asia and the Pacific remains home to two thirds of the world's poor. ADB is a multilateral development finance institution owned by 65 members, 47 from the region and 18 from other parts of the globe. ADB's vision is a region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their citizens.

ADB's main instruments for providing help to its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance. ADB's annual lending volume is typically about \$6 billion, with technical assistance usually totaling about \$180 million a year.

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Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
www.adb.org/microfinance

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