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The Impact of Interest Rate Ceilings on Microfinance Industry

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Abstract

Imposing ceilings on the interest rate has recently become one of the new hottest topics in microfinance industry; various debates have been discussing this issue to know the effect of interest rate ceilings on the supply of credit in particular and on microfinance industry in general. However in spite of the good intention behind these ceilings, there was no absolute result stating that ceilings have really contributed to the improvement or protection of the poor clients, indeed, these ceilings have hurt those low income people instead of helping them, due to these ceilings most of MFIs left the market or reduced their scale due to the inability to continue operating with low interest rate leaving the very poor clients without access to credit. Thus, the purpose of this paper is to review the impact of imposing such ceilings on the interest rates and to find out what alterative solutions can be employed as substitutes for them. This paper is entirely based on the secondary data collected from various records related to microfinance such as microfinance books, official websites and reports, published papers, and other sources related to the research subject.

Keywords: Microfinance, Ceilings, Rate, Interest, Industry

1. Introduction

The concern of the extension of tiny loans and other financial services along with social services to the unbanked micro entrepreneurs in poor societies has become one of the new hottest topics these days; its believed that these services work as effective instruments to mitigating poverty and creating job opportunities for low income people who have been excluded from the services provided by the conventional commercial banks. The term microfinance has been basically defined by the consultative group to assist the poor (CGAP) as "the *provision of financial services to low income people*".

Financial intermediations are supplied by various types of financial providers that vary from one country to another depending on the structure of the financial system in that country, these institutions often named as micro financial institutions (MFIs), their primary objective is to provide the un-served people in remote or urban areas with micro and small loans and other social services to enable them fight poverty and create new job opportunities for themselves. This shall, eventually, lead to attaining better standard of living for their households. However for these institutions to provide these services and remain sustained and active in the market, it is mandatory for them to cover their costs and expenses incurred when carrying out their activities. Various costs such as Cost of borrowing, cost of operation, inflation cost, cost of default loans and other costs of delinquencies with the profit margin have to be recovered by MFIs so that they can continue working smoothly and effectively in the market otherwise they have to depend largely on the government subsidies or the donors grants which do not last forever. These subsidies and grants affect negatively more than they help. For MFIs to cover these costs, they have to charge their borrowers a reasonable interest rate on loans supplied to them to be paid on monthly or yearly basis. These interest rates are mostly higher than the interest rates charged by the traditional commercial banks and other financial institutions. The reason behind this lies in that; loans disbursed by MFIs are very tiny and small unlike those provided by conventional banks. These micro loans need a lot of administrative expenses and personal effort to be restored from the clients who, generally, live in spaced remote areas. Though MFIs charge high rate of interest, still these rates are quite low when compared to interest rate charged by moneylenders and other pawnbrokers in the informal sector.

Charging high interest rate by MFIs creates worriers among various countries and governments in the world. The question which arises, here, is how can the financial institutions, established mainly for serving the disadvantaged poor people, charge them more than the regular commercial banks and other regular lenders in the market. This type of dilemma leads more than 40 countries in the world to impose ceilings on the interest rate demanded by MFIs as a way to protect micro entrepreneurs from this practice (CGAP, 2004). Such ceilings are the results of governments facing cultural or political pressure to keep interest rates low. Forcing such ceilings will make it very difficult for the MFIs to meet their needs and remain in market for long time. They ultimately have either to quit operation from the market or reduce their scale in remote rural areas along with reducing the transparency regarding the total cost of the loan. This, eventually, results in losing the chances for the poorest of the poor to access credit and other social intermediation. Thus, this study is an attempt to theoretically review the impact of interest rate ceilings on microfinance industry in general and on supply of micro credit in particular. The study will further show the role of donors and other practitioners in promoting alternative solutions to interest rate ceilings.

2. Methodology

A) Problem statement

Imposing of micro credit interest rate ceilings has created too much of debates on whether it is beneficial to the poor clients of MFIs or not and if yes what is the effect on microfinance industry in general and credit supply in particular. Therefore, the study is an attempt to identify the effect of these ceilings and the alternative possible solutions to them.

B) Objective of the study

The study shall identify the relationship between microfinance industry and interest rate ceilings and shall propose alternative solutions to these ceilings.

C) Importance of the study

The study shall add up a new existing literature plus it would be of a good help to various researchers, donors, practitioners and other parties interested in microfinance.

3. Previous Studies

In some of the conducted interviews by CGAP in (2004) with Alfredo Alaniz, the president of the association of Nicaraguan microfinance institutions, he reported that, the growth in the portfolio of the member institutions fell from 30% per annum to less than 2% when parliament imposed an interest rate ceiling in 2001. In another study by Freedom from hunger Agency as cited in Donor brief (2004), it was revealed that, when 27% interest rate ceiling was enforced in the West Africa, some MFIs left the remote and poorest of the poor communities and focused mainly on the urban areas where it can operate smoothly with the new ceilings.

4. Concept of Microfinance

The root of microcredit can be traced back to the beginning of the seventies when the noble peace prize Prof. Yunus provided the first loan amounted to US $27 to 42 poor women in jobra poor village of Bangladesh (Banker to the poor, 1997), his prime goal was to provide them with free collateral loans which can be used in the creation of new job opportunities for them that, eventually, will reduce their poverty level. However, the extension of only microcredit was not enough to the low income people to get them out of poverty, later on, the introduction of various other financial services such as micro-saving, micro-insurance, micro-leasing, money exchange, transfer services, remittance services and finally Islamic financial services came into existence. These financial services are provided along with some social services such as training, enterprise development, human and capacity building and other beneficial services. Providers of these services may have different forms which vary from formal to semi formal to informal institutions. They can have the form of commercial banks, micro financial institutions, programs, funds, foundations, finance companies, credit unions or any other form. The current landscape of microfinance in the globe has been shown by the 2014 microcredit summit campaign. The report revealed that the number of reached poor people by December 31, 2012 has increased to a total of 203,509,307 clients with a current loan. Of these clients, 115,584,445 were among the poorest when they joined their respective programs. Approximately 88.7% of the poorest clients reported are in Asia, a continent that is a home to over 62.4% of the world's people living on less than $1.25 a day.

5. Concept of Microcredit Interest Rate

For any financial institution wishes to deliver any kind of financial services to low income people or to other clients in the market and for obtaining a permanent source of credit for this institution, it is necessary to be permitted to charge its clients a reasonable interest rate to be able to cover various costs incurred by the institution when carrying out its operations. This is considered to be an essential element so that financial institution can sustain, become self reliant and operate effectively in the market. When interest rate is charged, dependency on the government subsidies and donors grants is reduced to large extent which means achieving self independence.

6. Interest Rate Ceilings Concept

The investopedia website has defined the ceiling of interest rate as *"The maximum interest rate that a financial institution can charge a borrower for an adjustable rate mortgage or loan according to the contractual terms of the mortgage or loan. This interest rate is expressed as an absolute percentage"*.

7. Impact of the Interest Rate Ceilings on the Supply of Credit

The moment government imposes interest rate ceilings, supply and demand do not interact freely in the market; the reason is that when there is a ceiling on the interest rate, the allocation of resources is not distorted if the equilibrium price is above the ceiling. This will result to excluding poor people who want credit but due to their incomplete qualifications they are not allowed to have it, which means the low income clients will move to the informal economy because they cannot attain the credit from the formal providers. The impact of interest rate ceiling on the supply of credit can be explained in the below diagram, P1 represents the price of the imposed interest rate and PE represents the price equilibrium and it shows that there is no way to increase the rate of interest to reach to PE which means there are no incentives to increase the quantity further , thus, this leads to shortage in credit supply in the market*." some suppliers may in fact leave the market altogether so that with the supply curve shifting inwards, the shortage will become even more acute"* (Black et la ,1997).which finally means increase of credit consumption.

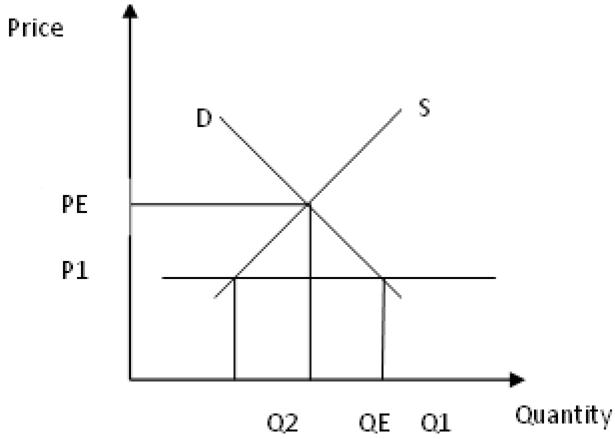

Figure 1. Impact of an interest rate ceiling on loan supply

Source: Black, Hartzenberg and Standish, 1997.

Imposing interest rate ceilings leads to three main issues:

- Shortage in credit supplied to the market
- Less transparency about the exact cost of the credit in the micro financial institutions
- Limiting the scope of operation of micro financial institutions
- Losing the chances of obtaining the loans for underprivileged class in the society

8. Main Components of Cost Structure in Microfinance

The structure for major costs in microfinance institutions (MFIs) comprises the followings:

- Borrowing cost
- Operation cost
- Delinquencies cost

When comparing microfinance costs with costs of commercial banks and corporate banks, it can be noted that, the cost of borrowing represents the main component in commercial banks whereas in microfinance industry, cost of operation represents the major cost which comprises around 70% of the total costs. Internationally, the cost structure of a financially sustainable MFI is represented graphically as below:

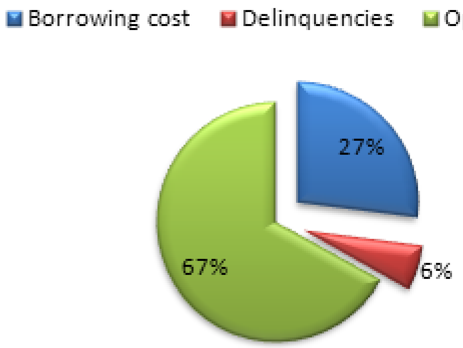

Figure 2. Cost structure of financially sustainable MFI

Source: Micro banking bulleting, issue number 14 spring 2007, A product of Mix www.mixmbb.org (as cited in Pakistan Microfinance Network July No: 8, 2009, p. 2).

9. Alternative Solutions to Protect the Poor Clients Other Than Imposing the Interest Rate Ceilings

To contribute to solving the dilemma of interest rate ceilings in microfinance industry, donors and practitioner have to participate in the followings:

➢ The establishment of consumer production law so that low income people can be provided with safeguard to protect them.

➢ Enabling innovation ecosystem of financial service providers

➢ Disclosing of the entire costs and other related charges of the loan publicly so that a poor client can easily compare with other suppliers of funds in the market.

➢ Providing proper education to policy makers in various countries regarding the negative effect of interest rate ceilings, and how it affects low income people and microfinance industry.

➢ Donors should set up a good example for others in lending practices; loans have to be lent to microfinance institutions without charging them a ceiling interest rate.

➢ Donors must participate in providing the micro financial institutions with the best required training and technical support to achieve high transparency along with professional standard reporting.

➢ Motivation and promotion of competition should be given full concentration and market expansion to be supported to introduce new different financial products and services.

➢ Donors should concentrate more on increasing the efficiency and effectiveness among micro financial institutions in the market.

- Industry infrastructure support has to be provided by donors and other international agencies.

- Support of expansion and diversification of microfinance institutions operating in the market

- Continuous consultation and training to management to make sure that everything is going perfectly

10. Conclusion

Introducing the concept of interest rate ceilings as a means for protection of the poor client from high charging by micro lenders has not really proved to be an effective method despite of the good intention behind it, however, many believe that lowering the interest rates is mainly a result of the continuous political and cultural pressure imposed over the governments and other authorities (CGAP, 2013). Forcing the micro financial institutions to lower their interest rate shall make them reduce the scale of operations and finally quit the market where the poorest of the poor need credit access, moreover, the transparency about the cost and other loan fees will be reduced by the MFIs. This is simply because these institutions cannot sustain there and thus they either have to leave the remote areas and operate in urban areas or close down the institutions. Efficiency is very important factor, Good competition, effective regulation, appropriate market structure and finally innovations are the key elements of the increase in efficiency. Donors play a key role in guiding the policy makers as how these interest rates affect the industry of microfinance, on the other hand proper training and promotions to be provided to micro financial institutions for betterment of their operations.

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