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*Helping to Improve Donor Effectiveness in Microfinance*

# THE IMPACT OF INTEREST RATE CEILINGS ON MICROFINANCE

*Interest rate ceilings are found in many countries throughout the world. With the expansion of microfinance in developing countries, many legislators and the general public have found it difficult to accept that small loans to poor people generally cost more than normal commercial bank rates. (For more information on why microcredit interest rate are higher than bank interest rates and how poor people afford these rates, please refer to Donor Brief 6, Making Sense of Microcredit Interest Rates). Though meant to protect consumers, interest rate ceilings almost always hurt the poor.*

## Are interest rate ceilings an effective way to protect poor customers?

Many countries have established interest rate ceilings to protect consumers from unscrupulous lenders. Governments often also face political or cultural pressure to keep interest rates low. Despite good intentions, interest rate ceilings generally hurt the poor by making it hard for new microfinance institutions (MFIs) to emerge and existing ones to stay in business. In countries with interest rate caps, MFIs often withdraw from the market, grow more slowly, become less transparent about total loan costs, and/or reduce their work in rural and other costly markets. By forcing pro-poor financial institutions out of business, interest rate caps often drive clients back to the expensive informal market where they have no or little protection.

**Nicaragua.** According to Alfredo Alañiz, President of the Association of Nicaraguan Microfinance Institutions, member institutions' portfolio growth fell from 30% per year to less than 2% when Parliament introduced an interest rate ceiling in 2001. *Source: Interview*

**West Africa (UMOA).** The central bank BCEAO and government Ministries of Finance enforce an interest rate cap of 27% for microfinance. Some MFIs are withdrawing from poorer, more remote communities, and many now focus on urban areas that are less expensive to serve. Some have also increased their average loan size (and presumably serve fewer poor clients) to increase returns. *Source: Freedom from Hunger*

**South Africa.** A recent review of credit laws found that interest rate caps contained in the current Usury Act and Credit Agreement Act have not been effective in protecting consumers. Credit allocation has been distorted to the detriment of low-income clients. In addition, some institutions have reduced transparency on the full costs of credit for poor clients by circumventing the caps through the introduction of credit life insurance and other charges. *Source: MFRC "Credit Law Review"*

## What are alternatives to protect customers?

To protect consumers from predatory lending, governments may pass **consumer protection laws or schemes**. Such strategies provide a desirable safeguard without the negative effects of interest rate ceilings. Consumer protection laws generally cover a set of non-prudential regulations, including mandatory disclosure on total loan costs; clearly defined complaint resolution procedures; consumer education to prevent abuse; and effective enforcement mechanisms.

**Public disclosure of loan costs** allows borrowers to comparison-shop for loans, stimulates competition among lenders, and compels them to become more efficient to stay in business. All MFIs should be able and willing to disclose their interest and fee costs to customers. Although disclosure is generally beneficial, it is not devoid of risk because it may draw political backlash due to the relatively high interest rates in microfinance. Disclosure is required in most developed countries as well as in some South American countries, such as Peru, Bolivia, and Colombia. In South Africa, the government has mandated the Micro Finance Regulatory Council (MFRC) to protect consumers and regulate microfinance institutions. The MFRC requires full disclosure of loan costs, offers a consumer complaint process, and runs consumer education campaigns on microlending. While microcredit interest rates will nearly always be higher than commercial bank rates, greater **efficiency, scale, and competition** can lead to lower interest rates. In Bolivia, BancoSol's effective interest rate (interest + fees) was 65% per year when it began operations in 1992 with 4,500 clients. Today, in a highly competitive

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market and with 55,000 clients, its annual interest rate is 22%. In Cambodia, in its relatively new but highly competitive microfinance market, interest rates have dropped from around 5% to 3.5% per month over the past few years. In some provinces where MFIs are particularly active, moneylenders have dropped their rates to match those of the MFIs.

**What can donors do about interest rate ceilings?**

- **Set a good example.** To have a credible dialogue with government policy makers, donors must support market interest rates themselves. Donors should not impose interest rate ceilings for on-lending their funds or subsidize interest rates in the programs they finance.

- **Inform and educate policy makers.** Donors can engage with government policy makers in many ways. They can organize in-country seminars about microfinance and appropriate interest rates and/or they can fund the attendance of policy makers at international microfinance training programs. Donors can also bring in policy makers from similar countries with appropriate microfinance policies.

> The Swiss Development Corporation (SDC) has been working closely with ASOMIF in **Nicaragua** to counteract the 2001 interest rate legislation. Together, they have organized seminars and held ongoing discussions with both the executive and legislative branches of government. SDC has also supported ASOMIF's work on a law that created a new category of microfinance institutions that are not subject to the interest rate ceiling.
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> In **Laos**, UNDP and UNCDF were able to charge an interest rate in their microfinance project that exceeded the accepted government norm. This result required negotiation and continual dialogue with high-level officials. To support their arguments against interest rate ceilings, UNDP and UNCDF hosted a visit from Central Bank representatives from Cambodia where market interest rates prevail.

- **Support transparency and standard reporting, including an emphasis on efficiency.** Donors can require that financial institutions use effective performance monitoring systems and transparent financial reporting that include efficiency indicators. Well-designed performance monitoring systems enable MFIs to know their costs and take steps to streamline their procedures for efficiency gains. As MFIs become more efficient, they are able to lower their interest rates. Donors can also support national microfinance networks' efforts to introduce industry-wide systems, standards, and benchmarks, and promote the use of ratings and external audits. Standardized and transparent financial reporting sets the stage for full public disclosure of lending costs, and helps identify the full costs of making loans as well as any inefficiencies.

> Although there is no official interest rate ceiling in **Ethiopia**, the government controls the largest MFIs in the country and tries to keep interest rates artificially low. The Association of Ethiopian Micro Finance Institutions has helped its members develop standard reporting and performance monitoring tools. When the MFIs were able to track their complete costs for the first time, they could defend the need to charge interest rates that reflect their costs adequately.

- **Foster competition and growth.** Donors can foster competition by financing diverse types of institutions that offer financial services to the poor. Increased competition will often lead to lower interest rates throughout a microfinance industry. Donors can also support MFIs to achieve greater outreach and grow so that they can benefit from economies of scale and lower their interest rates over time.

**Author:** Ann Duval, with input from CGAP staff. **Sources:** This note synthesizes Brigit Helms and Xavier Reille, *The Impact of Interest Rate Ceilings on Microfinance*, CGAP Focus Note (Washington, DC: CGAP, forthcoming 2004). **More information:** Kieran Donaghue, "Interest Rates in Microfinance" (unpublished paper, Canberra, Australia, 2002). Micro Finance Regulatory Council, "Credit Law Review" (Pretoria, South Africa: Department of Trade and Industry, August 2003). Joselito Gallardo, "A Framework for Regulating Microfinance Institutions: The Experience in Ghana and the Philippines," Working Paper 2755 (Washington, DC: World Bank, Financial Sector Department, January 2002). Amha Wolday, *Revisiting the Regulatory and Supervision Framework of the Microfinance Industry in Ethiopia*, DCG Proceedings No. 13 (Ås, Norway: Drylands Coordination Group, August 2001). Paul McGuire and John Conroy, *The Role of Central Banks in Microfinance in Asia and the Pacific*, Vol. 1, *Overview* (Manila: Asian Development Bank, 2000). Robert Peck Christen, Timothy R. Lyman, and Richard Rosenberg, *Guiding Principles on Regulation and Supervision of Microfinance*, Microfinance Consensus Guidelines (Washington, DC: CGAP, July 2003). David L. Wright and Dewan A.H. Alamgir, "Microcredit Interest Rates in Bangladesh: Capping vs. Competition" (unpublished paper, March 2004).