

The Paradoxical Case Against Interest Rate Caps for Microfinance

- And: How Fintech and RegTech Resolve The Dilemma -

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Since 2010 approximately 40 developing countries and transitional economies imposed interest rate caps. This article analyses the impact of these interest rate caps on microfinance institutions. Introducing the taxonomy of soft, mezzo and hard interest rate caps we take a stance against hard interest rate caps arguing that the downsides of such hard caps outweigh the benefits. Our article is structured as follows: In Pt. II we show that regulatory materials published in the context of cap implementation reveals four justifications for imposing interest rate caps, including consumer and client protection, fraud prevention and exploitation by deceptive credit providers, support for a particular strategic industry or sector, and combating anti-competitive behavior where the costs of credit exceed the actual cost of lending plus a reasonable profit margin. We argue that these arguments do not justify the imposition of hard interest rate caps: We challenge each of the four arguments, arguing that hard interest rate caps, as one-size-fits-all solutions are too blunt an instrument to distinguish between the different service levels and industry environments in which microfinance institutions operate. We outline that hard interest rate caps prompt two unwanted consequences instead: increasing the importance of the informal credit sector, and furthering the microfinance institution's mission drift. We also show that the comparison with Northern low-interest economies is flawed. Drawing on financial and regulatory technologies we develop alternative solutions. First, the most adequate way to reduce too high interest rates is furthering competition among all institutions that could provide credit. Rather than distinguishing between regulated banks, microfinance institutions and mobile money and lending providers all of these three groups constitute the respective credit market, and competition between the three branches of credit markets is, in principle, desirable, if the policy objective is competition on the merits. This requires the development of well function credit registers, disclosure of effective interest rates and the facilitation of digital financial services.

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I. Reanimating the dead: Interest caps as old and new trend in the Global South

During the second wave of financial inclusion, microfinance institutions funded primarily by Western donors and investors became increasingly important.¹ At that time, hard interest caps were deemed a phenomenon of the past. However, recent experience tells us that this was incorrect.

First, a range of studies found that the median interest rate of (microfinance institutions) MFIs around the world was 26%pa in 2006,² 35%pa in 2008³ and 27%pa in 2011.⁴ Some regard these already high numbers as too low since they ignore the effect of compulsory savings.⁵ However, more significant than the median were the results from the extremes of the range, with the average rate in Uzbekistan exceeding 80%pa and 17%pa in Sri Lanka. These extreme positions triggered regulatory responses,⁶ as they left the impression that the world's poorest parts of society pay the world's highest cost for microfinance and small business capital.

Subsequently, approximately 40 developing countries and transitional bodies imposed interest rate caps.⁷ The impact of these caps is not yet entirely understood. The official reasoning, the advantages and – from our perspective – serious disadvantages of hard interest rate caps for microfinance and financial inclusion will be discussed in this paper. With a view

¹ On the stages of microfinance policies see the study of Jason Lin & Jane Sung, *Comparative Study of the Regulatory Framework on Microfinance*, 3 J. BASIC APPL. RES. 53–58 (2017), at 56. They researched the specific banking laws and regulations for each country to evaluate about the strictness of its laws and regulations over microfinance institutions, stating as follow: '...Four different categories were used to determine the strictness of the regulations imposed on microfinance institutions. One, if there were specific microfinance institution laws in place in the country to govern these institutions. Two, if the microfinance institutions were required to have a minimum start-up capital requirement. Third, if there were interest rate restrictions on the amount of interest the institutions could charge on the loans that they give out. Fourth and final, if there are additional financial ratios that need to be maintained by the institutions throughout their operations. The last three categories were evaluated by whether the specific requirement was imposed by specific microfinance laws or the regular banking laws of the country.' ; on MFIs donor see also Bert D'Espallier et al., *From NGOs to Banks: Does Institutional Transformation Alter the Business Model of Microfinance Institutions?*, 89 WORLD DEV. 19–33 (2017), <http://dx.doi.org/10.1016/j.worlddev.2016.06.021>, at 34, stating that 'The global microfinance sector has continued growing regardless, though it has undergone structural changes. Initially a purely philanthropic idea, microfinance started out in the 1970s as a not-for-profit activity sponsored by donors.'; Anis Chowdhury, *Microfinance as a Poverty Reduction Tool — A Critical Assessment*, UN 1–13 (2009), at 5 (stating: 'Jonathan Morduch's (2000) panel discussion with senior and experienced donors and NGO representatives in Colombia suggests that not more than 5 percent of microcredit programmes world-wide could become financially viable without subsidy.' Chowdhury continues by citing The Economist on July 16, 2009 mentioning that: 'Despite growing interest from private investors, 53% of the \$11.7 billion that was committed to the microfinance industry in 2008 still came at below-market rates from aid agencies, multilateral banks and other donors').

² Richard Rosenberg, Adrian Gonzalez & Sushma Narain, *Are Microcredit Interest Rates Excessive?*, February CGAP BR. February (2009), at 2.

³ Christoph Kneiding & Richard Rosenberg, *Variations in Microcredit Interest Rates*, CGAP BR. July (2008), at 1.

⁴ Richard Rosenberg et al., *Microcredit Interest Rates and Their Determinants: 2004–2011*, in MICROFINANCE 3.0: RECONCILING SUSTAINABILITY WITH SOCIAL OUTREACH AND RESPONSIBLE DELIVERY 69–104 (Doris Köhn ed., 2013), at 75.

⁵ Aneel Karnani, *Regulate Microcredit to Protect Borrowers*, 1133 ROSS SCH. BUS. WORK. PAP. (2009), at 12.

⁶ Kneiding and Rosenberg, *supra* note 3, at 1.

⁷ Cf. on the different types of authority used for imposing interest rate caps Brigit Helms & Xavier Reille, *Interest Rate Ceilings and Microfinance*, Sept OCCAS. PAP. No 9 1–19 (2004), at 1.

to identifying a better solution than hard interest rate caps, we propose alternative means to further the policy goals of achieving the adequate or ‘fair’ interest rate outcomes that regulators had in mind when imposing hard interest caps.

In this paper, we focus on hard interest caps, a subset of interest rate caps. To be clear, we do not argue against regulatory or social mechanisms that aim to achieve ‘fair’ interest rates. Some type of interest mitigating device is available in more than half of all countries around the world: A World Bank study from 2014⁸ lists 76 of 152 countries (around 40%) within the World Bank universe that apply some type of interest cap. These countries include Australia, the Bahamas, Canada, Germany and the United States.⁹ **However, we take a stance in this paper against hard interest rate caps.** Clarifying the terminology is of prime importance. We distinguish between three types of interest caps. First, in the case of ‘soft caps’, social ethics, or a gentlemen’s agreement among a nation’s economic and political elites serves to keep interest rates low.¹⁰ Second, **mezzo caps** may enforce social norms and prohibit usury practices by demanding fair interest rates. Enforcement usually takes place via private law mechanisms, such as denying the enforcement of a usurious contract in court. Finally, a **hard cap** fixes an interest rate on an absolute level (for example 20%) or a relative level (for example 10% over a benchmark rate). Such a cap is often enforced by a central bank or a government agency.

In the area between hard and mezzo caps, we find other caps, enforced by a central bank or bank regulator, that refer to the average interest rate charged by similar institutions. Such a cap may, for example, be 33% more than the average effective interest rate charged by microfinance institutions. We will show that, although these types of interest rate caps avoid some of the specific disadvantages of hard caps, they still exhibit some of the broader disadvantages of interest rate caps we identify in this paper *if* they are enforced by a central bank or other government agency. This justifies discussion of these caps in the context of hard interest rate caps, although we are aware of the thin line between these and the mezzo caps we find in many jurisdictions.

As shown in Table 1, at least 31 hard interest caps have been introduced since 1973; with the majority in developing or emerging economies.

⁸ Samuel Munzele Maimbo & Claudia Alejandra Henríquez Gallegos, *Interest Rate Caps around the World: Still Popular, but a Blunt Instrument*, 7070 WPS 1–37 (2014), at 5-7.

⁹ See on interest rate caps, in general, Timothy E. Goldsmith & Nathalie Martin, *Interest Rate Caps, State Legislation, and Public Opinion: Does the Law Reflect the Public’s Desires?*, 89 CHIC. KENT. LAW REV. 115 (2014), at 129-130.

¹⁰ Helms and Reille, *supra* note 7, at 10 (citing Ghana and Ethiopia as examples for countries where all interest rate caps were removed, yet majority of their MFIs have chosen to preserve a lower interest rate and this artificially low interest rate is intimately linked to political pressure).

Figure 1: Interest Rate Caps Around the Globe - 1973-2017

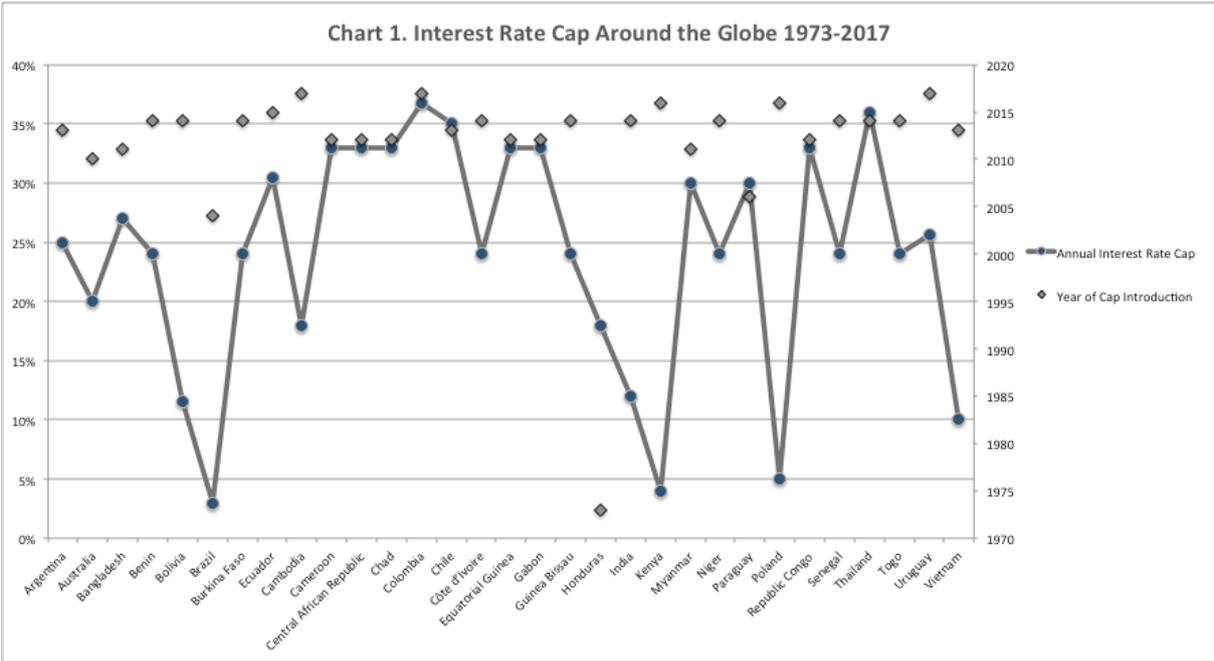


Table 1: Hard interest caps around the world (references are provided in Annex 1#)

Country	Date of cap introduction	Maximum allowed interest
Argentina	2013	25%.
Australia	7/2010	One-off establishment fee of 20% (maximum), monthly account keeping fee of 4% (maximum).
Bangladesh	7/2011	27% for microcredit loans.
Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Niger, Senegal, Togo	2014	15% for banks, 24% for other financial institutions, Decentralized Financial Systems (DFS) and other economic agents. (Set by the Central Bank of the UMOA - Union Monétaire Ouest Africaine or West African Monetary Union/WAEMU).
Bolivia	4/2014	Interest rate cap for microfinance is 11.5%, for small productive sector is 7% and medium and big productive sector is 6%
Brazil	2004	Up to 4% per month or up to 3% in those with a maturity of 120 days or more.
Cambodia	4/2017	18%.
Cameroon, Central African Republic, Chad, Equatorial Guinea, Gabon, Republic of the Congo	2012	The microfinance sector interest rate should be calculated on the nature of the credit provided and if the interest rate exceeds 33%, it is risky. (Set by the CB of CEMAC - Communauté Economique Et Monétaire De L'Afrique Centrale or The Economic and Monetary Community of Central Africa).
Chile	1981, upd. 2013	Around 35%
Colombia	2010, upd. 2017	36.76%.
Ecuador	2015	Depends on the amount of the given loan (Microcrédito de Acumulación Ampliada, Microcrédito de Acumulación Simple or Microcrédito Minorista), it ranges from 25.50%-30.50%.
Honduras	January 18, 1973	Law Regulation for Non-Banking Lenders: 18% annually for loans with mortgage guarantee and 24% annually for loans with pledge or personal guarantee.

India	2011, upd. 2014	26% on microfinance loans for up to 50,000 Rupees (2011); since April 2014, 10% for large MFIs (loans portfolios exceeding Rs.100 crore), 12% for the others.
Kenya	9/2016	No more than 4% over the base rate set and published by the Central Bank of Kenya.
Myanmar	2011	2.5% per month, 30% annually.
Paraguay	2003, with almost every month upd. Since 2006 in its CB website	Not exceed 30% the average of the annual effective rates received by the Banks and Financial Institutions on the consumer loans, according to the terms and coins in which credits are granted.
Poland	2016	Central Bank Rate plus 3.5% (per 1 January 2016: 5%).
Thailand	Q1/2014	All costs (interests and fees) not more than 36%.
Uruguay	2007, upd. 2017	Cash loans in local currency provided by financial intermediation companies have obligatory average rates: for micro-company and household with period up to 366 days, it ranges between 25,67% to 33,87%.
Vietnam	6/2013	9% for credit institutions and foreign bank branches, 10% for the People's Credit Funds and Microfinance Institutions

The **argument in favor of interest rate caps** is straightforward: If banks and MFIs may not charge interest beyond a certain rate they will consequently not charge *excessive* interest. Hence, the cost of credit will go down and more people will have access to credit.¹¹ Looking more closely, interest rate caps are often justified by an intention to *improve* access to finance. By making credit more affordable to the underserved they prevent consumers from becoming over-indebted, they prevent predatory lending, and they indirectly subsidize strategic economic groups who would otherwise have restricted or no access to finance.¹²

This paper argues that the case for hard interest caps is, generally speaking, unfounded and that the **seemingly plausible mathematical justification is flawed**. Further, it argues that hard interest rate caps may lead to unwanted consequences that are detrimental to poor people's access to finance. Part II presents the official reasoning in favor of hard interest caps. Part III reveals the differences between MFIs and commercial banks in terms of credit risk, transaction and operational costs. Part IV argues that any one-size-fits-all solution, such as a hard interest rate cap, disregards the differences *among* MFIs and is thus harmful to a certain subset of MFIs that we refer to as 'high cost, high service' MFIs. This is the subset of MFIs that are active in less crowded and less accessible rural areas where financial inclusion is particularly difficult to achieve. In turn, the informal credit sector will be strengthened and mission drift will increase. Part V identifies the often aired argument that interest rates in the Northern Hemisphere tend to be much lower than in the Southern Hemisphere. In Part VI we consider alternative measures to influence credit market efficiency in the Southern Hemisphere, and argue that a transparent credit register and regulatory leniency given to digital financial services maximizes benefits and avoids most of the flaws of hard interest rate caps. Part VII concludes.

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¹¹ See Nimal A. Fernando, *Understanding and Dealing with High Interest Rates on Microcredit: A Note to Policy Makers in the Asia and Pacific Region*, ASIAN DEV. BANK 1–13 (2006) at 4 (revealing that lower microcredit interest rates will help increase the depth and breadth of availability of affordable finance for poor households, yet the author emphasizes that imposing microcredit interest rate caps is not the answer).

¹² Marco Azzalini, Valeria E. Pujia & Katia Raguzzoni, *Microfinance in Palestine: Are Loans too Expensive and Should Interest Rates be Capped?*, 1 ECON. DEV. POLICY BR. 1–8 (2016) at 5, available at http://www.itcooper.org/sites/default/files/English_23%20AGOSTO%202016_FINAL.pdf (last accessed 23 November 2017).