Research Note N°1 on Microfinance Regulation

Interest Rate Restrictions and Microfinance: Insights from Cambodia[1]

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Interest rate restrictions have often been set in financial inclusion schemes. Yet, such regulations may present drawbacks affecting both microfinance institutions and their clients. This note presents a case study carried out in Cambodia, where an interest rate cap has recently been set. Beside the insights directly related to the case, theoretical conclusions are drawn to help regulators better understand what to consider when seeking to intervene in a microfinance market.

As microfinance institutions (MFIs) developed, harsh debates rapidly emerged about the high rates charged to poor, excluded individuals. Crises, ethical issues, doubts regarding the impact of MFIs on poverty reduction, and the saturation of microcredit markets in some regions have catalyzed these debates (Guérin et al., 2018). As a response, regulators have sometimes believed that limiting the rates charged by MFIs would take them back to their social mission and prevent the poor from exploitation. Still, restrictions on lending rates may affect MFIs' sustainability and operations and, consequently, their clients.

This note presents a research exploring the issue of interest rate caps in a sector being under a particularly high pressure: the Cambodian microcredit market. After years of impressive growth allowing more and more people to access formal services, the market has got increasingly saturated. In 2017, the regulator limited rates at 17% to slow it down. Through a qualitative case study carried out in Cambodia, this research draws insights from the analysis of this particular situation. Unintended consequences of the cap, uncovered by the literature, are highlighted thanks to the Cambodian case. A theoretical reflection is then proposed to better grasp what to consider when intervening in a microcredit market through regulation.

Capping lending rates: the rationale

Many regulators have used interest rate caps. In 2018, Ferrari et al. (2018) pointed 76 countries capping rates. Three main arguments or intentions are typically expressed in favor of such a regulation:

- *Protecting clients from financial exploitation*. This is the most common argument. Caps would reduce market power, so that dominant lenders would set rates as if in a competitive market.
- *Preventing over-borrowing*. By limit the access to high interest loans, caps would prevent borrowers from bearing excessive rates and prevent business failures resulting from exorbitant funding costs.
- *Slowing down microcredit markets*. Some authors have argued that such restrictions affect the ability to enter the market and thereby limit extreme, unhealthy competition. For this reason, caps would help slow down saturated markets experiencing excessive growth.

Yet, although these good intentions are honorable, interest rate restrictions have been criticized for several reasons by the academic literature, but also by support actors such as the World Bank or the CGAP.

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[1] The views expressed in this note are those of the authors and not necessarily those of ADA. For more details on this research, please contact directly the corresponding author at tristan.caballero-montes@umons.ac.be.

Interest rate caps and microfinance: a good idea only at first sight?

From a general perspective, price restrictions often result in destabilizing the provision of a given good or service. Indeed, from an economic point of view, if regulators expect the restriction to be efficient, they need to set it under the equilibrium price. However, doing so, they automatically force some suppliers, in this case financial service providers (FSPs), to withdraw their offer, as unable to sell (or lend) at the regulated price. This thus leads to a reduction of supply and the exclusion of a part of the demand. In the case of the provision of credit, this leads to a possible credit crunch and the exclusion of clients, especially among the riskier, needing higher rates than what the cap allows.

Looking now at microfinance, interest rate caps may be even more difficult to support. Indeed, given the profile of the clients served, the part of the demand excluded from accessing loans is likely to be centered on those generating higher costs or greater risks. Especially, lenders may be less inclined to serve poorer or more remote clients who typically require small loans or generate higher costs due to their inaccessibility. Moreover, clients with less (financial) literacy and without collateral may now be perceived as too risky to serve for certain operators. As a result, caps may be even more problematic when it comes to microcredit, as those excluded are already among the most marginalized. Moreover, while it could be argued that a cap could theoretically be set at a "reasonable" level, such level is typically difficult to figure out in practice, given the huge variety of FSPs. Among others, the types of clients served, the funding strategy, the location, the currency used… render the often one-size-fits-all character of interest rate restrictions inappropriate and unsustainable for many operators.

Besides, caps are also criticized as FSPs can usually easily go around the restriction by increasing ancillary fees and commissions, bundling loans with other products, or asking for compulsory savings, among others. Finally, it is to note that caps are sometimes used with political intentions, which often results in poorly designed restrictions making no economic sense (Helms and Reille, 2004).

All in all, the literature suggests that, despite their a priori good intentions, interest rate restrictions may induce perverse effects and be inefficient. Yet, they have often been used by regulators, at the image of the Cambodian microfinance market where a cap has recently been set. The case study presented below describes the motivations and consequences of this restriction for the local microfinance sector.

The Cambodian case

Cambodia has known a very dynamic growth and the microfinance industry has been no exception. While the number of micro-borrowers has plateaued around 2.5 million since 2015, the current average outstanding loan quadrupled since then, to locate around 3500 USD in 2018, almost 200% of the GDP per capita (M-CRIL, 2019). In 2015 already, Cambodia was considered as one of the most saturated credit markets in the world (MIMOSA, 2015). This growth has particularly been exacerbated by the harsh competition and the fight for greater market shares. The situation has been detailed in several studies (LICADHO, 2019; World Bank, 2019) and most observers now agree to consider Cambodia as dangerously saturated.

This case study consisted in the collection of data from various sources. First, through a two-month field work, key actors including CEOs, COOs, and other employees of MFIs; representatives of the National Bank of Cambodia and the Cambodia Microfinance Association (CMA); and micro-borrowers were interviewed. Second, the CMA, the local professional network, provided relevant internal studies and documents related to the regulation and its consequences. It also allowed to deeply grasp what microfinance in Cambodia is. Finally, based at the CMA, the study benefited from data collected through observation and through the scrutinizing of the local business and financial press.

Restricting lending rates in a saturated microcredit market

With the situation of the Cambodian microcredit market in mind, namely a particularly competitive industry, several points could be highlighted thanks to the case study. First, although it seems that the cap was efficient in reducing the rates, its impact on financial inclusion must be nuanced:

- *Many MFIs indicated that they shifted to larger loans* to remain viable or maintain their profit. On this matter, interviewees concluded that clients were excluded or provided with larger loans, the latter indicating that they bear higher risks and are more exposed to (over-)indebtedness.
- *Some MFIs indicated that they paid more attention to urban clients* after the cap was set, to the detriment of rural ones, in order to reduce costs.

MFIs seemed also to be affected in terms of sustainability, which may lead to detrimental consequences for the clients on the long run:

- *Sustainability has been impacted.* While this mostly concerned small and medium operators rather than larger ones, most MFIs mentioned that profits and margins were affected. Some explained for instance that they closed branches, fired people, or reduced investments.
- *Funding costs increased.* This is one of the most surprising effects. Cambodian MFIs largely rely on funding from banks. Some funders perceived the cap as an additional risk to their survival and so reviewed the price of their funding, making it even more difficult to be viable.

Drawing more general conclusions

Following this, interest rate restrictions seem irrelevant as a tool to protect the poor, overall when it comes to a saturated and competitive market just like the Cambodian one. After all, encouraging healthy competition, financial education and transparency may be softer means affecting rates while generating no or less side effects. Still, this case study allows to draw general insights regarding an intervention from regulators:

- *All costs should be concerned by the regulation.* If MFIs can go around with extra fees or commissions, the regulation will end up being inefficient;
- *Restrictions should make economic sense* (and not support political intentions);
- *Restrictions should enable FSPs to adapt* to avoid sudden changes resulting in drastic shift, detrimental to clients;
- *Market specificities must be considered* to make sure it suits the variety of MFIs.

Besides, the research suggests a theoretical framework to help regulators integrate market conditions in their decision-making process and justify when/if intervening may be required or, contrarily, unjustified. It is based on two criteria: the level of interest rates and the degree of competition in a market considered. As suggested by Appendix 1, some situations may justify an intervention from regulators, especially when interest rates are judged – based on multiple and objective criteria – as high, and when competition is not taking place or cannot be mobilized. In these cases, other tools such as financial education or transparency may be better options. On the contrary, when interest rates are low or when healthy competition may be mobilized, there is a priori no reason to resort to interest rate restrictions that may hurt rather than help.

Applying this framework to more than 50 countries, two main insights emerged: First, *the regulation in place in more than half of the countries is not aligned* on the recommendation. This means that these countries take other factors into account to decide whether to intervene. Second, *countries in unions, such as the UEMOA, apply uniform regulations while facing different market conditions*. This shows the importance of adapting regulation to local market conditions to make sure it is efficient and not harmful.

	Uncompetitive market	Competitive market
High interest rates	**Situation 1: An intervention is justified** High prices probably result from a lack of competition (monopoly, oligopoly)	**Situation 2: An intervention may be justified** Competition is emerging but not effective yet or is effective but does not affect prices
Low interest rates	**Situation 3: No intervention is justified** Low rates but not thanks to competition (not-for-profit actors, self-regulation...)	**Situation 4: No intervention is justified** Clients get good prices, probably thanks to "textbook competition"

Appendix 1. Regulatory options: Theoretical framework

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