



Interest Rates in Bangladesh Microcredit Market

Interest Rates of Microcredit: The Controversy

Right from the start of microcredit programme in late 1970s, there has been a strong criticism of high interest rates charged by MFIs. In recent years, the criticism that Microfinance Institution (MFIs) charge its poor borrowers unreasonably high interest rate has intensified. Some people point out the unfortunate combination of profit-seeking MFIs, minimal competition and vulnerable borrowers has opened up dangerous potential for exploiting the poor. In the backdrop of these concerns and criticisms, this policy paper reviews the interest practice of MFIs in Bangladesh, examines the issue of interest rate from the perspectives of MFIs and the borrowing members.

Interest Rates of Microcredit: How Much the Borrowers Really Pay

Several factors determine the effective interest rate (EIR), which is the actual price of the loan that the borrower pays: a) the stated interest rate; b) the method used to calculate the interest rate—simple versus compound interest rate; c) the method in which the principal of the loan is treated in calculating the interest rate—the declining balance method or flat method.

EIR for the Borrower Will Depend on:

- **Payment schedule:** As the number of installment increases the EIR also increases. If the flat rate of interest for a principal of Tk 1000 was 12.5%, the effective interest rate, if paid by weekly installments would be nearly 31.3% and it will go down to about 25.1% if the loan is paid back by monthly installments.
- **Grace Period:** As the grace period increases, EIR decreases. For a loan of Tk 1000 at 10% flat rate with no grace period, the effective rate would be 25.1%. this would go down to 22.3% if 4 weeks of holidays are allowed and the amount is paid in 48 weeks and not in 44 weeks.
- **Other charges:** Insurance or forced savings.
- **Fees:** Application fee, loan processing fee, security money, pass book fee etc.

Figure: Estimates of EIR under Different Systems of Repayment

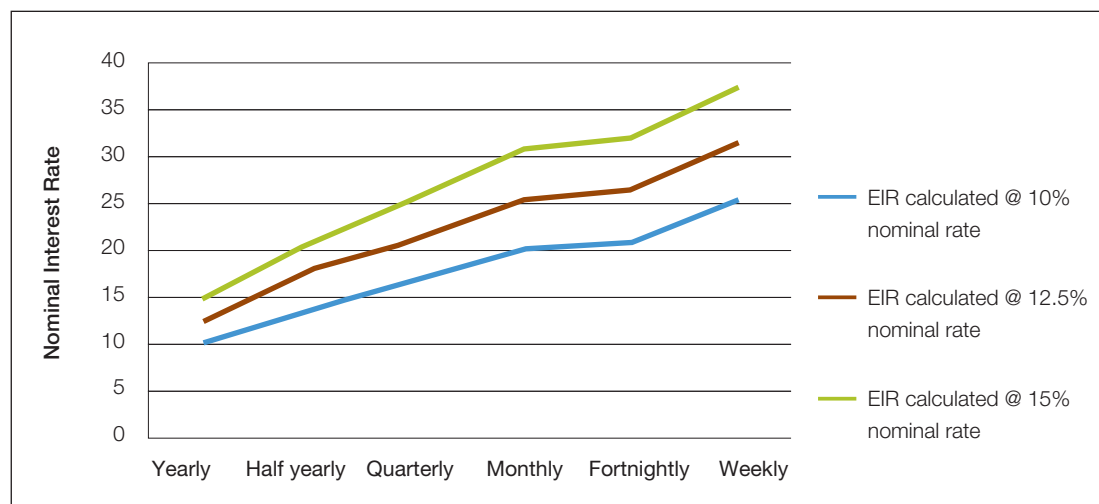


Table 1

EIR Calculated under Different Conditions of Deduction at Time of Loan Disbursement (%)
(Effective interest (%) calculated at 12.5% nominal rate of interest and the loan to be paid in 45 weeks)

Conditions	Deduction amount (Tk.)	Average Loan Amount (Tk.)			
		1000	3000	5000	10000
Initial fixed deduction (of various kinds noted earlier)	0	27.66	27.66	27.66	27.66
	15	31.81	29.03	28.52	28.09
Initial deduction as % of loan amount	0.1	27.98	27.98	27.98	27.98
	1	30.45	30.45	30.45	30.45
	5	42.35	42.35	42.35	42.35
	5+5%	44.03	42.89	42.71	42.50

Source: Authors

Interest Rates of Microcredit: MFI Perspectives

In fixing interest rate, MFIs point out that they usually take the following factors into account:

- Cost of Funds
- Administrative Expenses: According to CGAP, administrative costs of MFIs tend to vary between 10% and 25%. The Bangladesh MFIs operate somewhere at the mid-point with average operating cost of around 18 percent. During 2006-09, it had demonstrated relatively cost effective level of operating cost of operations.
- Contingency Reserves (Provision for Bad Debt): Globally, good MFIs maintain provision of 1-2 percent. In Bangladesh, it exhibits an increasing trend. The rate varies between 2-3 percent.
- Tax expenses
- Credit Rating of Client
- Capitalisation Rate: This refers to the net profit of MFIs once inflation is accounted for. According to CGAP, an average of 5-15% capitalisation rate is used.

The Break-Even Rate in Bangladesh

Taking all costs into account, the average break-even rate (which could be regarded as the floor interest rate) in Bangladesh is between 23%-24%.

Efficiency of the MFIs in Bangladesh

One basic problem of analysing interest rate purely from the supply side is that the borrower may be paying a price for inefficiency of the operations of MFI. It is, therefore, desirable that a benchmark is determined that will correspond to the cost structure of an efficient MFI. It seems Grameen Bank had been most efficient compared to other MFIs operating in an unregulated environment. Most other MFIs are less efficient than Grameen, although there is a decreasing trend in inefficiency level of the MFIs. Even accepting some degree of inefficiency, 23-24% is the breakeven rate which means that 27% interest ceiling on a declining method should be acceptable for the MFIs in Bangladesh.

Table 2

Average Break- Even Interest Rate of MFIs in Bangladesh during 2006-2009

Per Taka 100 Loan	2006	2007	2008	2009
Operating Cost	17.33	17.68	16.44	16.23
Loan Loss	1.49	1.85	2.76	3.07
Cost of Fund	3.97	4.51	4.17	3.87
Break-Even Rate (Floor Rate)	22.63	23.79	23.21	22.84

Source: M. A. Baqui Khailly (2011); "Is Lending Interest Rate High in MicroCredit Market?" (Draft report)

Interest Rates of Microcredit: Borrowers' Perspectives

- Since the funds could be used on enterprises could vary a great deal and the fact that some of the funds could be used for meeting consumption needs during hard times or for meeting unforeseen expenditures, whose economic value may be indeterminate or unlimited. So this alone cannot be good criterion to judge whether interest rate is high.
- An assessment of whether a price of a product is high or not is reflected in the demand for the product. Surveys on demand for Microcredit and access to finance of the poor or near poor (who cannot provide any acceptable collateral for borrowing from commercial or specialised banks) show that:
 - The formal sectors do not provide flexible products and services to meet the income and expenditure patterns of small borrowers.
 - The transactions costs of dealing with the formal sectors are high resulting not only from the significant travel time to bank branches but also from cumbersome procedures and the need to pay hefty bribes (10 to 20 percent of the loan amount) in a significant number of cases.
 - Formal sector institutions demand collateral, predominantly land, which poor rural borrowers lack.
- In comparing Microcredit interest rates with other rates paid by low income borrowers, the following facts are often referred to:
 - MFI rates are significantly lower than consumer and credit card rates in most of the 36 countries, which had rate indications, and significantly higher than those rates in only a fifth of the countries.
 - Based on 34 reports from 21 countries, MFI rates were almost always lower—usually vastly lower—than rates charged by informal lenders.
 - MFI rates were typically higher than credit union rates in the 10 countries. In the cases, where the credit unions offered a specialised microcredit product, their interest charges tended to be the same as, or higher than, prevailing MFI rates.
- Finally from the perspective of borrowers, one can also ask whether borrowers in Bangladesh paying too high interest rates compared effective interest rates charged by MFIs in other countries and continents. We have no comparative data of effective interest rates charged around the world. Some information is available on real interest rates of some countries weighted by number of borrowers and it clearly shows that the average real interest rate on microloans in Bangladesh is lower than most countries in attached table.

Table 3

Annual Interest Rates of Commercial Banks, Moneylenders and MFIs (2003)

Country	Commercial Banks APR	MFIs APR	Informal Sources (e.g. moneylenders) APR
Indonesia	18%	28-63% (BPRs, local-level microbanks)	120-720%
Cambodia	18%	~45%	120-180%
Nepal	11.5% (priority sectors) 15-18% (other)	18-24%	60-120%
India	12-15% (to SMEs)	20-40%	24-120% (depending on state)
Philippines	24-29%	60-80%	120+%
Bangladesh	10-13%	20-35%	180-240%

Source: Brigit Helms and Xavier Reille. September 2004. "Interest Rate Ceilings and Microfinance: The Story So Far". Occasional Paper, CGAP. Wright and Alamgir, "Microcredit Interest Rates in Bangladesh", based on data prepared by Sanjay Sinha.

Table 4

Average Real Interest Rates Weighted by Number of Borrowers

Country	Borrowers 2005 (millions)	Average Interest Rate 2005 (%)
Bangladesh	8.8	20.1
Bolivia	0.5	20
Cambodia	0.4	27.6
India	1.8	24.5
Indonesia	3.3	22.2
Mexico	1.1	46.6
Morocco	0.6	29.4
Peru	1.3	32.8
Philippines	0.7	46.7

Source: CGAP 2007, Portfolio, 4/2004, New Regulatory Challenges: http://www.cgap.org/portal/binary/com.epicentric.Contentmanagement.servlet.ContentDeliveryServlet/PORTFOLIO/PORT_Apr2007Data.html

Interest Rates of Microcredit: A Critical Overview

- The highest and lowest average effective annual interest rate charged by 40 partner organisations of PKSf show a range of 24% to 32%.
- If we take the range of interest rates charged by each of these partner organisations, it will be wider, from 18% to 36%.
- The range becomes even wider, if we take MFIs outside the POs of PKSf—it can be as wide as 22% to 110% (taking all deductions into account).

Table 5
Highest, Lowest and Average EIR among the 25 POs for Different Products (%)

Products	Highest EIR	Lowest EIR	Average EIR
Rural Microcredit	35.75	28.11	32.05
Urban Microcredit	34.73	28	32.35
Microenterprise (weekly payment)	34.67	28.39	31.59
Microenterprise (monthly payment)	30.39	25.30	26.65
Ultra Poor Programme	26.55	18.15	23.91
Seasonal	35.74	21.32	26.68
Agriculture	34.73	24.88	28.46

Source: Palli Karma-Sahayak Foundation (PKSF)

Recently MRA announced guidelines for MFIs to follow:

- Maximum interest chargeable set at 27.00 (twenty seven) percent per annum.
- Calculation of interest on loans on a Declining Balance Method.
- Minimum number of installments on general loans must be 46 (forty six).
- There will be a grace period of a minimum of 15 (fifteen) days (for loan given for one year) between the date of loan disbursement and the repayment of the first installment.

Policy Recommendations

- Interest rates charged by MFIs must legitimately cover fully its operating costs, but those costs should correspond to the costs of efficient MFIs.
- Setting interest rate caps on microcredit is advisable only when there are signs of market failure (such as lack of information flow to borrowers and absence of competition among MFIs).
- Transparency and some kind of uniformity in interest rates charged for similar type of loan and use of declining balance method in calculating interest rate would be highly desirable.
- Industry infrastructure (e.g., credit bureaus, auditor training) will have to be developed and supported.
- Different types of institutions associated with MFIs (e.g., NGOs, credit unions, microfinance banks) will have to be supported and promoted.