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Finance for All

Post Covid-19 Priority

How Competitive Are Lending Rates of MFIs in Bangladesh

In the post Covid-19 world, an important priority for the MFIs in Bangladesh is to explore the long standing controversy relating to the issue of charging 'excessively high interest rates' from the borrowers. The issue is important for the MFIs both for fulfilling their social mission as well as for ensuring financial and institutional sustainability as socially responsible institutions.

Over the last five decades since independence, microfinance has advanced financial access for the poor especially among the poor women in Bangladesh. One of the aims of devising the microfinance programmes has been to mitigate the credit market imperfections in countries like Bangladesh where the poor do not have access to formal financial institutions mainly because of lack of collateral and other constraints and they are forced to resort to informal credit markets (such as moneylenders), who charge exorbitantly high interest rates on loans.

Still, there exists wide-spread evidence that the MFI borrowers in Bangladesh borrow from informal sources as part of their financial management strategy. Recent theoretical development points out that the response of the interest rates in the informal sector to the expansion of formal credit depends on the characteristics of both sectors, such as market structure in the informal sector as well as the repayment schedules of the formal sector. One empirical study on the impact of MFI programmes on the moneylender interest rates in northern Bangladesh shows that moneylender interest rates increase with rising share of households borrowing from MFIs while productive investment of loans lowers the moneylender interest rates.

However, greater coverage of MFI programmes increases moneylender interest rates in areas in which more loans are invested in productive economic activities. The above can be explained by the fact that as loans are utilised for productive purposes, the likelihood of repayment increases so that moneylenders are able to charge lower interest rates. But, if the overall demand for loans goes up and if MFI loans are inadequate or seasonal working capital is unavailable from the MFIs or the repayment schedule is tight, the borrowers resort to moneylenders for additional funds to sustain their production activities. Hence, the increased demand for funds drives up moneylender interest rates.

Thus, the borrowers can make more productive investments if MFIs meet their demands for loans by allowing more flexibility in loan disbursement and

repayment schedules and expand their programme of loan-only to loan-plus to reduce the moral hazard problem faced by the moneylenders. From a global perspective, the active presence of the moneylenders is thus not necessarily harmful, and can even be beneficial if increasing competition between formal and informal lenders increases the borrowers' access to funds at competitive interest rates.

However, there has also emerged a popular discontent over the years regarding the effectiveness of microfinance in alleviating poverty for which the policy makers have decried, among others, the excessively high interest rates charged by the MFIs.

The skepticism arises from a number of issues, such as:

(i) high interest rates acting as a deterrent for the poor borrowers;

(ii) inflexibility of loan terms and borrower knowledge resulting in loan defaults and falling further into poverty;

(iii) poor women's (who are the prime beneficiaries of microfinance) inability to utilise microfinance loans for their own use due to familial pressures and lack of societal empowerment;

(iv) inadequate education and skills among the rural borrowers preventing them from using microfinance productively; and

(v) greater competition from alternative sources (e.g. agent banking which mitigates the problem of geographical immobility) with lower interest rates on loans than those disbursed by MFIs) leading to lower microfinance activity.

Despite these and other criticisms, a recent World Bank study covering the period from 1992-2011 shows a positive effect on reduction of extreme poverty and a positive increase in farm and non-farm activities due to microfinance growth. Further, microfinance in Bangladesh has become diversified in its reach and now facilitates savings and insurance, microenterprises, and productive employment in addition to disseminating important information to help the borrowers. Microfinance also helps to smoothen the after-effects of environmental shocks such as floods, cyclones and other calamities, to which the poor in Bangladesh in both urban and rural areas are especially susceptible. The 20 year-long World Bank research on the effectiveness of poverty reduction in Bangladesh shows that the benefits microfinance brings to families in poverty are tangible, particularly to the next generation in supporting education, health, higher standards of living and women empowerment.

As a response to the high interest rate criticism, many countries including Bangladesh have established interest rate caps on microfinance loans. In 2010, the authorities in Andhra Pradesh, India closed down 50 branches of MFIs following allegations of usurious interest rates, adversely affecting the reputational cost to the microfinance sector which had an impact on the sector well beyond India. The subsequent social and economic cost of drying credit lines to the poor was significant as well. The response of the governments was swift, and a number of countries curtailed the high interest rates by creating an interest rate cap. In May 2011, the Reserve Bank of India (RBI) established the cap at 26 per cent on loans less than INR 50,000 and in April 2014, RBI introduced a more flexible rate: cost of funds (at market rates) plus 10 per cent for existing MFIs and cost of funds plus 12 per cent for new MFIs. The Microcredit Regulatory Authority (MRA) of Bangladesh fixed an interest rate cap of 27 per cent on microloans effective July 2011. In 2019, MRA fixed the interest rate cap at 24 per cent for microfinance loans. In February 2021, MRA has formed a committee to review the cap again.

Since the introduction of caps, there has also emerged a controversy regarding whether interest rate cap undermines microfinance's original mission to financially empower the poor. Some argue that stringent restrictions on interest rates limit product innovation and competition, and act as an incentive for the MFIs to up-scale at a faster rate to the detriment of the poorer groups.

Nevertheless, since the beginning of microfinance, its

most controversial dimension has been the interest rates charged by the MFIs. These rates are higher--often much higher--than normal bank rates, mainly because it inevitably costs more to lend and collect a given amount through thousands of micro loans than to lend and collect the same amount in a few large loans.

Higher administrative costs have to be covered by higher interest rates. But the issue is: How much higher? Many people worry that the poor borrowers are being exploited by excessive interest rates, given that these poor borrowers have little bargaining power, and that an ever-larger proportion of microfinance is moving into for-profit organisations where higher interest rates could, as the story goes, mean higher returns for the shareholders.

Another major problem relating to microfinance is that the interest rate presented to its customers often differs radically from the actual percentage rate (APR) that an MFI charges, once the calculation method, timing, upfront fees and compulsory savings are accounted for. For example, many microfinance loans use a flat, rather than declining balance, based on which interest is calculated. A loan quoted as 4 per cent interest per month using flat method would have a 79 per cent APR rather than 48 per cent. This misinformation prevents borrowers from making informed decisions and the market from working efficiently. The difference is reportedly large for providing the smallest loans to the poorest and the rural clients, as they have the highest operating expenses for MFIs and thus must charge the highest interest rates to remain viable.

Government intervention that caps interest rates, rather than ensuring efficient lending regulations, may encourage the MFIs to provide larger loans to the better off poor in more accessible areas, contributing to the retreat of the MFIs from their mission to serve the poorest and the hard-to-reach locations.

Further, pricing transparency is likely to enable the poor customers to make informed choices, create competition in the market, and enable the market forces to work more effectively, making interest rates more competitive and pressuring MFIs to streamline their operational costs. The MFIs having greater transparency are likely to perform better than those with less transparency. Research on financial transparency shows that such transparency is positively correlated with better performance indicators due to a greater level of trust between the MFIs and their customers.

The major problem with interest rate caps is that they may hurt the poorest by making it unprofitable for the MFIs to provide the small and short-term loans. However, pricing caps may benefit the MFIs by encouraging them to strive for organisational efficiency that would allow them to operate profitably with lower interest rates. The MFIs can only sustain their existence through striking a balance between their development goals and business interest. And this puts a challenge for the MFIs to their ability to provide credit services at cost on par with the formal banking system. The key therefore is to identify ways for the MFIs to be profitable, achieve scale and continue to serve the poorest while achieve their double bottom line of social impact and financial sustainability.

Issues in MFI Loan Pricing

It is true that the MFIs in Bangladesh operate under significant financial constraints. They serve the unbankable, face high risks of default, provide small loans, operate in remote areas, use labour intensive methods, and strive to reduce reliance on subsidies to achieve financial sustainability. As such, high interest rate for MFI loans (relative to other formal credit) is considered as inevitable.

One may further argue that MFI loans and commercial bank loans are not the same products; these are highly differentiated in terms of both quantity and quality. Nevertheless, the impact of high interest rates on the poor has emerged as a widespread concern in the country's development discourse. The problems associated with high interest rates are multiple and may include the reduction of both

borrowers' surpluses and the demand for, and uptake of, microfinance services; inability to keep up with interest payments; over-indebtedness; exacerbation of financial burdens; socioeconomic stresses; and the reduction of the overall well-being of the poor borrowers. There is an emerging concern that high interest rates are one of the central reasons why MFIs may fail to ensure the well-being of the poor and microfinance to serve as an efficient and effective poverty alleviation tool.

The 'structure-performance' paradigm predicts that if a microfinance sector has multiple sources of monopoly power, it is more likely to engage in anti-competitive behaviour, such as charging higher interest rates. Thus, a competitive environment in microfinance may contribute to the promotion of allocative and productive efficiency which lowers cost and interest rates.

On the other hand, increased competition may lead to lower standards of screening and monitoring, increased asymmetry of information, a weaker MFI–borrower relationship, multiple loan taking, over-indebtedness, and high default rates. If defaults on loans rise, then MFIs may respond by increasing interest rates. Competition may reduce MFIs' use of joint liability, which in turn may reduce repayment rates and increase interest rates. At the same time, higher interest rates may affect the riskiness of the pool of loans by crowding out safer borrowers or by inducing borrowers to invest in riskier activities, both of which may lower profits of the MFIs.

Therefore, an alternative is to reduce the number of disbursed loans and introduce stricter credit standards instead of increasing interest rates. Consequently, the impact of competition on interest rates of MFIs may not be predictable. The empirical evidence on the impact of competition on interest rates is inconclusive and often provides counterintuitive results.

The setting of interest rates for MFIs has always been a controversial issue in Bangladesh. On the one hand, high interest rates of MFIs are justified by one group because of the higher-than-normal operating and processing costs of the packaged loans ('credit plus plus') for serving very small loans of the poor borrowers without collateral; while, others argue that high interest rate is charged either because the MFIs are earning too much return or due to the persistence of their operational and other inefficiencies.

As a consequence, relatively 'high' interest rates are charged to those who can least afford them — the poor people. Many MFIs use the original Grameen Bank model, setting rates around +15 per cent above the cost of funds. The initial vision of Professor Yunus was that interest rates would decline with time, thus allowing the MFIs to pass along savings to micro-borrowers while competing and serving their social mission. Unfortunately, even almost 50 years later this vision has not been realised and the debate on interest rates remains a sore point in Bangladesh and many other countries. Thus, MFIs have been facing more than ever before an ethical question: Are the MFIs undergoing a mission drift? And, what should be the 'just' interest rate for the MFIs to charge from the poor borrowers?

The debate on interest rate caps will undoubtedly continue over the years as mobile technology and mobile money play an increasingly significant role in MFI operations, reducing operating costs and improving transparency. The realisation, however, requires borrower education by the MFIs, and innovations on how the new technology will help in achieving the benefits. The creation of microfinance 'credit bureaus' with mandatory membership for the MFIs could act as a 'transparency' tool for reviewing indebtedness and repayment history; in the absence of which appraising a borrower's credit-worthiness becomes expensive, time-consuming, and often inaccurate.

As the sector develops, the regulator (MRA) is more likely to re-examine the interest rate cap issue, along with other important issues including implementation of sector lending priorities, diversification of funding, and channeling of deposits towards the MFIs. As the industry moves forward, MRA will try to find the optimal balance to ensure that the objectives and

operations of MFIs are well-tuned at serving and benefiting the micro-borrowers.

Historically, efficiency and competition, along with rising micro loan sizes, have been the main factors behind the decline of most MFI interest rates in the last decades. No doubt, finding the optimal regulatory balance is a challenging task, involving considerations related to protecting the interests of both the MFIs and the borrowers, loan sizes, minimising the costs of MFIs and its supervision, and preventing regulations from restricting innovation and competition. The challenge is not to enact more regulations rather to have smarter regulations in order to ensure that the MFI interest rates are fair, transparent and provide reasonable protection to the MFI customers, while also allowing viable MFI business operations and market development.

In view of the above and related concerns, it is high time that an in-depth analysis is necessary to examine the central issue facing the policymakers as well as the MFIs: How 'rational' is the interest rate charged by the MFIs in Bangladesh? In view of the multiple determinants of rationality, the issue will have to be examined from a number of perspectives. One major perspective will be to assess the level and trend of MFIs interest rate and break down the interest yield into its main components (e.g. cost of funds, loan loss expense, operating expenses and loan size, operating surplus, etc.) to analyse their evolution.

The analysis will through light on, for example, what has happened during the period, on average, on whether

(i) operating expenses have declined as MFIs have become more efficient;

(ii) financial expenses have changed significantly as the funding sources have transformed;

(iii) loan losses have increased; and

(iv) interest yield and operating surplus have changed. The analysis should be disaggregated into size of MFIs (e.g. small. medium and large), geographical variation (e.g. rural, urban and hard-to-reach locations), loan portfolio (e.g. extreme poor, moderate poor, microenterprise loans etc.), and other observable dimensions.

Another major perspective could be to compare the changes in components for MFI interest rates with similar changes in lending rates of other financial institutions (e.g. commercial banks, NBFIs, cooperatives etc.) to explore the differences and draw comparisons and policy implications. Moreover, the contribution of the components in Bangladesh's microfinance sector could be compared with similar changes in microfinance sector of global and other comparable countries.

The issue of differential of MFI interest rates presented to the customers from the actual percentage rate (APR) that the MFIs charge, once the calculation method, timing and payment schedule, grace period, upfront fees (e.g. insurance, application fee, loan processing fee, security money, pass book fee etc.) and compulsory savings are taken into account should also be examined.

Overall, the analysis should suggest a rational set of principles for guiding the interest rate policy and practices of MFIs to promote both the welfare and sustainability objectives of the MFIs. The thrust should be to focus on the underlying contributors that tend to result in 'high' interest rates charged by the MFIs and recommend necessary steps to increase the operational efficiency of MFIs enabling the MFIs to charge competitive interest rates from the poor borrowers and enhance their welfare and sustainable graduation from poverty and deprivations.

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