Research Note N°2 on Microfinance Regulation

Investigating the Interplay between Interest Rate Caps and Competition in a Financial Inclusion Context[1]

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Many regulators have been tempted to cap the lending rates of microfinance institutions, that is, to limit the rates charged to poor and financially excluded clients through microcredit. This has been even truer since the industry commercialized and drew the attention of the public opinion and authorities. Yet, is the outcome of such regulation the desired one? Besides, is this outcome sensitive to market conditions? This note addresses these key questions for regulators to better understand the impact of market conditions on the outcome of their decisions.

While they serve the poor and excluded, microfinance institutions (MFIs) have often been criticized regarding their high interest rates. Although dealing with the marginalized requires a different, costlier model than traditional money lending, regulators are often unsatisfied with the idea that the poor bear higher rates for borrowing. For this reason, many regulators have set interest rate caps in financial inclusion schemes. In 2018, at least 76 countries were capping interest rates (Ferrari et al., 2018).

Yet, is the outcome of such restrictions really the desired one, namely to protect the poor? Although opinions diverge, the idea that caps would be socially counterproductive and result in the exclusion of the poorest has emerged. However, the discussion still presents grey areas. First, there seems to be no large quantitative research confirming this perverse effect of financial exclusion. Case studies of specific markets testify of the outcomes of caps in some circumstances but do not allow to draw general conclusions. Second, the literature on regulatory issues in financial inclusion contexts has developed over the last decades but markets have evolved. While competition remains relatively low in certain parts of the world, it has been encouraged, and even exacerbated, in others. Still, the state of competition is usually not considered in the studies on caps, while regulation may present different outcomes in different contexts. The present research aims at contributing to fill those gaps through a large econometric study.

Capping rates in microfinance

Practitioners and support actors such as the World Bank have argued at various occasions that caps would restrict small or remote borrowers to access microcredit (Maimbo and Henriquez Gallegos, 2014). Unlike mainstream credit, small loans entail a high cost per unit, as high operational costs are generated[2] and spread on tiny amounts. Yet, setting interest rate caps causes several problems. First, just like any price restriction, a cap inevitably induces a loss of supply and a possible credit crunch, as some providers are not able to lend anymore at the regulated price set by the cap (see Figure 1).

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

[2] Microcredit requires a costlier business model, inducing especially to go often on the field and deal with lowly educated, remote clients with no collateral. Sociological reasons linked to socio-economic differences between commercial banks' staff and microfinance clients also require adapted lending methods (Labie, 2004).

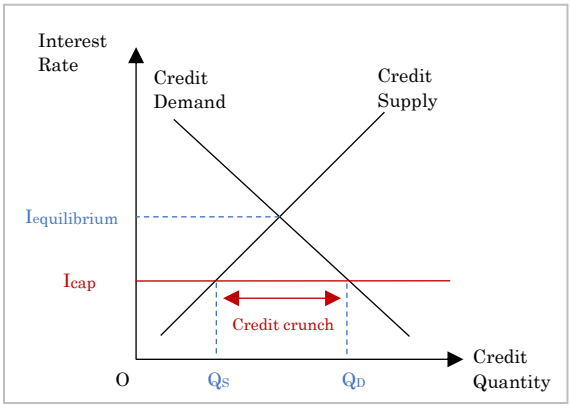

Figure 1. Effect of a cap on the credit market

Second, imposing a unique limit in an industry with an incredible diversity of operators, just like MFIs, is likely to be inappropriate for many of them. Different MFIs typically present different cost structures, funding strategies, client targeting and profiles, physical constraints… that make uniform restrictions unsustainable for diverse reasons. Third, when caps are imposed, they are often set too low to allow the smallest loans to be viable. As often, restrictions are imposed for all or most financial service providers, including commercial banks bearing lower costs than MFIs. As a result, MFIs would try to go around the restrictions. Especially, they would be encouraged to target clients generating lower costs, namely clients allowing larger loans. Yet, while providing larger loans certainly allows to better spread costs and charge lower rates, it also leads to target better-off, less excluded, and/or more accessible clients, who can afford larger loans.

Some case studies developed this rationale and suggested that caps penalize the most marginalized, including the poorest, but also rural and women clients (Latortue, 2004; Attuel-Mendès and Ashta, 2008). Still, no global quantitative research has focused on the issue yet.

Confirming the intuition

Tackling this first issue, data were collected from various sources to access information on the use of interest rate caps in financial inclusion schemes around the world. The *Global Microscope on Financial Inclusion* provided important information for many countries. It was completed by contacts with central banks, professional networks, and other actors; desk review of legal documents and press releases; and inventories of the use of caps coming from recent academic research. This was then combined to the MIX Market's and the World bank's open data to build a final dataset of 986 MFIs, from 73 countries, for 2015-2018, representing 2591 observations. Fixed effects regressions were run on a model with the average loan size as dependent variable. The model includes a bunch of common firm- and country-level variables.

The first finding of the research indicates that *MFIs facing interest rate caps tend to provide larger loans on average*. This confirms the intuition that emerged from the literature and suggests that, everything being equal, MFIs operate a shift in their strategy when they face rate restrictions and provide larger loans. This suggests that they try to spread lending costs on larger amounts and, this way, generate lower costs. Doing so, they are likely to turn to better-off clients, able to bear such larger loans.

Although this finding is interesting on its own, it is kind of an "overall" result. Is it similar, though, no matter what market the cap is implemented in? (How) does competition affect this outcome? Going one step further, this research investigates whether competition interacts with the outcome of interest rate caps.

Integrating market conditions to the analysis: does competition matter?

Competition is measured here through various indicators (# of MFIs, Herfindahl-Hirschman Index, and Lerner Index), for robustness purpose, and injected in the model to operate a moderation analysis.

The findings indicate that the effect of caps on the size of the loans provided by MFIs is amplified by competition. In other words, everything being equal, *caps induce that*

MFIs provide larger loans, even more when they face additional competition. This suggests that competition exacerbates the financial exclusion effect of interest rate caps.

The academic literature highlights ambiguous effects of competition on financial inclusion through microcredit. Several explanations may be proposed here:

- *Competition may jeopardize the ability of MFIs to cross-subsidize*, a key process for their viability (Morduch, 1999). Cross-subsidization consists in providing larger loans to better-off clients to compensate for the smaller, costlier loans offered to poorer ones. Yet, as a profitable business, microfinance attracts profit-driven organizations, which reduces the basket of better-off clients available for socially oriented MFIs.
- *Competition exacerbates informational asymmetries* (McIntosh et al., 2005). When no optimal platform exists to centralize credit information, MFIs may be tempted to "over-lend" to clients who cannot bear it.
- *Competition may make it more difficult for small MFIs to keep up the race to efficiency and costs reduction* (Kar and Swain, 2014). While small structures such as NGOs are often less efficient, they however typically deal with poorer clients and thus provide smaller loans.

Conclusion

Microfinance has become a mature and major economic sector in certain parts of the world. Markets have evolved and new trends have emerged, including digital services affecting the business model of MFIs. Investigating questions about what kind of industry is desirable, for both MFIs and their clients, is now essential. Regulatory and market dynamics issues are thus key to tackle.

This note presents a research aiming at understanding better the outcome of interest rate caps on the financial inclusion of the poor. It also aimed at investigating to what extent market conditions affect the outcome of regulatory decisions related to rate caps in microfinance. The results confirm what has been debated but not really tested: interest rate caps present perverse effects related to financial exclusion. Going one step further, it shows the importance of integrating market conditions in the parameters of regulatory choices. In this case, competition seems to be an additional burden for the MFIs facing a cap and to amplify undesired outcomes.

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