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Interest rate caps and their impact on financial inclusion

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Abbreviations

CGAP	Consultative Group to Assist the Poor
IPO	Initial Public Offering
MFI	Microfinance Institution
MIX	Microfinance Information Exchange
MSME	Micro, Small or Medium sized Enterprise
NGO	Non-Governmental Organisation
NPL	Non-Performing Loan
RR	Repurchase (repo) Rate
SME	Small or Medium sized Enterprise
UMOA	Union Monétaire Ouest Africaine (West African Monetary Union)

1 Introduction

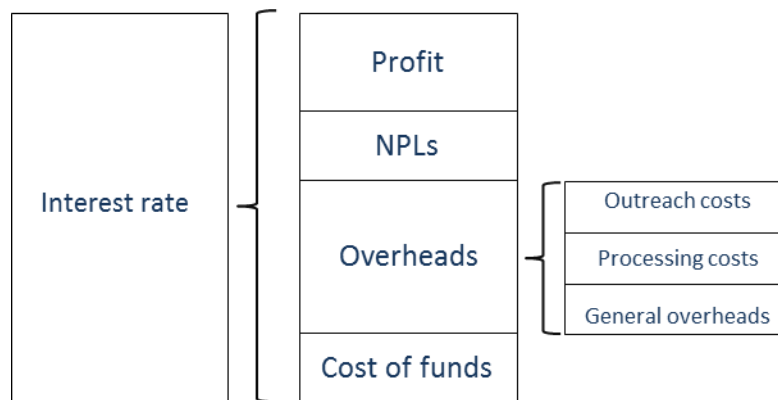
The recent introduction of a lending rate ceiling for banks and other financial institutions in Zambia reopened an old debate¹ over the appropriateness of regulatory intervention to limit the charging of rates that are deemed, by policymakers, to be excessively high. This short paper studies the theory behind interest rate caps and aims to answer the following questions:

- i) Where are interest rate caps currently used, and where have they been used historically?
- ii) What have been the impacts of interest rate caps, particularly on expanding access to financial services?
- iii) What are the alternatives to interest rate caps in reducing spreads in financial markets?

1.1 Understanding the composition of the interest rate

In order to assess the appropriateness of an interest rate cap as a policy instrument, or whether other approaches would be more likely to achieve the desired outcomes of government, it is vital to consider what exactly makes up the interest rate and how banks and MFIs are able to justify rates that might be considered to be excessive. Broadly speaking there are four components to the interest rate.

Figure 1: Breakdown of interest rates²



The cost of funds is the amount that the financial institution must pay to borrow the funds that it then lends out. For a commercial bank or deposit taking microfinance institutions this is usually the interest that it gives on deposits. For other institutions it could be the cost of wholesale funds, or a subsidised rate for credit provided by government or donors. Other MFIs might have very cheap funds from charitable contributions.

The overheads reflect three broad categories of cost. The first is the general administration and overheads associated with running a network of offices and branches. The second is the cost of credit processing and loan assessment, which is an increasing function of the degree of information asymmetry. Finally, there are outreach costs; the expansion of a network or development of new products and services must also be funded by the interest rate margin. It is the overheads, and in particular the processing costs, that can drive the price differential between larger loans from banks and smaller loans from MFIs. Overheads can vary significantly between lenders and measuring overheads as a ratio of loans made is an indicator of institutional efficiency.

Lenders must also absorb the cost of bad debts that must be written off in the rate that they charge. This allowance for non-performing loans (NPLs) means that lenders with effective credit screening processes should be able to bring down rates in future periods, while reckless lenders will be penalised.

¹ The issue particularly came to the fore during the financial liberalisations of the 1990s and again as microfinance increased in prominence with the award of the Nobel Peace Prize to Muhammad Yunus and Grameen Bank in 2006

² Author's own design

The final charge that lenders will include is a profit margin that again varies considerably between institutions. Banks and commercial MFIs with shareholders to satisfy are under greater pressure to make profits than NGO or not-for-profit MFIs.

1.2 The rationale behind interest rate caps

Interest rate caps are used by governments for a range of political and economic reasons, most common of which is to provide support to a specific industry or area of the economy. It may be the case that government has identified what it considers to be a market failure in a certain industry, or that an interest rate cap is an attempt to force a greater focus of financial resources on that sector than the market would determine. Common examples are loans to the agricultural sector to boost agricultural productivity (as in Bangladesh) and loans to credit constrained SMEs (as in Zambia).

It is also often argued that interest rate ceilings can be justified on the basis that financial institutions are making excessive profits by charging exorbitant interest rates to clients. This is the usury argument³, and is essentially one of market failure: government intervention is required to protect vulnerable clients from predatory lending practices. The argument, which is predicated on an assumption that demand for credit at higher rates is price inelastic, postulates that financial institutions are able to exploit information asymmetry (and in some cases short run monopoly market power) to the detriment of client welfare. Aggressive collection practices for non-payment of loans have exacerbated the image of certain lenders.

Economic theory suggests that market imperfections will result from information asymmetry and the inability of lenders to differentiate between safe and risky borrowers⁴. When making a credit decision, a bank or a microfinance institution cannot fully identify a client's potential for repayment. Two fundamental issues arise:

- Adverse selection: clients that are demonstrably lower risk are likely to have already received some form of credit. Those that remain will either be higher risk, or lower risk but unable to prove it. Unable to differentiate, the bank will charge an aggregated rate which is will be more attractive to the higher risk client. This leads to a raised probability of default *ex ante*.
- Moral hazard: clients borrowing at a higher rate might be required to make riskier investments in order to cover their borrowing costs. This leads to a higher probability of default *ex post*

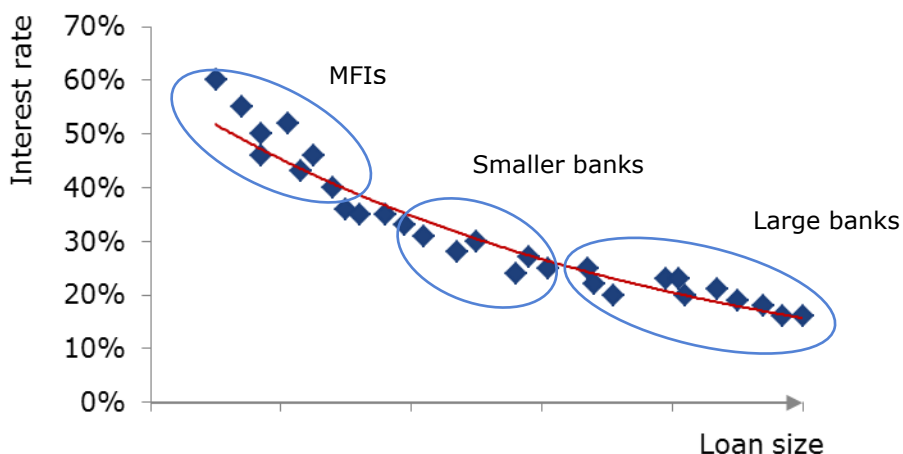
The traditional microfinance group lending methodology helps to manage adverse selection risk by using social capital and risk understanding within a community to price risk. However, interest rate controls are most often found at the lower end of the market where financial institutions (usually MFIs) use the information asymmetry to justify high lending rates. In a non-competitive market (as is likely to exist in a remote African village), the lender is likely to hold the monopoly power to make excessive profits without competition evening them out.

Typically the financial markets will segment so that large commercial banks service larger clients with larger loans at lower interest rates and microfinance institutions charge higher rates of interest on a larger volume of low value loans. In between, smaller commercial banks are often able to find a niche serving medium to large enterprises. Inevitably some individuals and businesses will be unable to access credit from either banks or MFIs – the *missing middle*. This scenario is depicted below.

³ Office of Fair Trading (OFT), Price Controls: Evidence and arguments surrounding price control and interest rate caps for high-cost credit (May 2010)

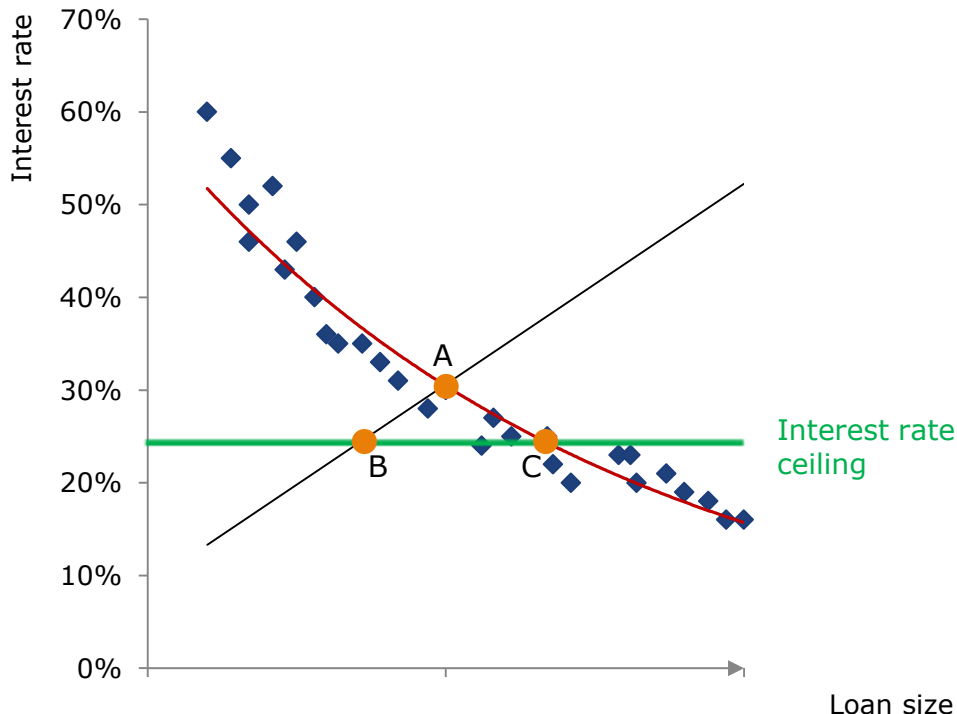
⁴ Stiglitz, Joseph and Weiss, Andrew, Credit Rationing in Markets with Imperfect Information (June 1981)

Figure 2: Demand schedule for financial services⁵



That basic interest rate caps are most likely to bite at the lower end of the market is intuitive; interest rates charged by microfinance institutions are generally higher than those charged by banks⁶ and this is driven by a higher cost of funds and higher relative overheads. Transaction costs make larger loans relatively more cost effective for the financial institution. If it costs a commercial bank \$100 to make a credit decision on a \$10,000 loan then it will factor this 1% into the price of the loan (the interest rate). The cost of loan assessment does not fall in proportion with the loan size and so if a loan of \$1,000 still costs \$30 to assess, the cost which must be factored in rises to 3%. This cost pushes the higher rates of lending on smaller loans. The higher prices are usually paid because the marginal product of capital is higher for people with little or no access to it. This leads to the standard supply and demand diagram as shown below.

Figure 3: Imposition of an interest rate ceiling⁷



⁵ Stylized graph of the author's own design

⁶ Kneiding, Cristoph and Rosenberg, Richard, Variations in Microcredit Interest Rates (July 2008) CGAP Brief

⁷ Stylized graph of the author's own design

In implementing a cap, government is aiming to incentivise lenders to push out the supply curve and increase access to credit while bringing down lending rates – that is, move from equilibrium A to a new equilibrium at C in the above graph (this assumes that the cap is set below the market equilibrium – if above then lenders will continue to lend as before).

However, such thinking ignores the actions of the banks and MFIs operating under asymmetric information. The imposition of a maximum price of loans magnifies the problem of adverse selection as the consumer surplus that it creates is a larger pool willing borrowers with unidentifiable creditworthiness. Faced with this problem, lenders have three options:

- Increase lending, which will mean lending to more bad clients and pushing up NPLs
- Increase investment in processing systems in order to better identify good clients, which will increase overheads
- Increase investment in outreach to clients that can be identified as having good repayment potential, which will increase overheads

All of these options will increase costs and force the supply curve back to the left, which is detrimental to financial outreach (quantity of credit falls). Unless financial service providers can absorb the cost increases while maintaining a profit, they may ration credit to those that they can readily support at the prescribed interest rate, refuse credit to other clients and the market moves to point B.

The question therefore becomes: is this story of interest rate caps leading to credit rationing borne out in reality? The remainder of this paper aims to answer this question using examples from interest rate caps imposed in a range of economies. Section 2 describes where caps have been used and how they have varied in practice, section 3 analyses the impact if these on the supply of and demand for finance, and section 4 considers the alternative options for bringing down interest rates.

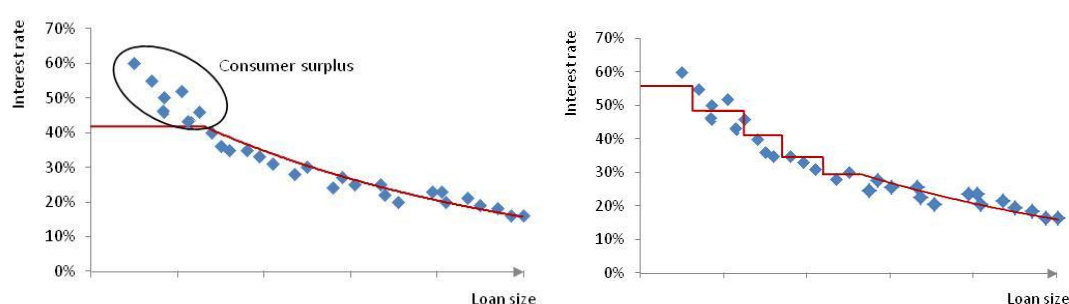
2 The use of interest rate caps

Though conceptually simple, there is much variation in the methodologies used by governments to implement limits on lending rates. While some countries use a vanilla interest rate cap written into all regulations for licensed financial institutions, others have attempted a more flexible approach.

The most simple interest rate control puts an upper limit on any loans from formal institutions. This might simply say that no financial institution may issue a loan at a rate greater than, say, 40% interest per annum, or 3% per month.

Rather than set a rigid interest rate limit, governments in many countries have found it preferable to discriminate between different types of loan and set individual caps based on the client and type of loan. The logic for such a variable cap is that it can bite at various levels of the market, minimising the consumer surplus.

Figure 4: Fixed versus variable interest rate cap



As a more flexible measure, the interest cap is often linked to the base rate set by the central bank in setting monetary policy. This means that the cap reacts in line with market conditions (rises with monetary tightening, falls with easing). This is the model used in Zambia⁸, where banks are able to lend at nine percentage points over the policy rate and microfinance lending is priced as a multiple of this. Elsewhere, governments have linked the lending rate to the deposit rate and regulated the spread that banks and deposit taking MFIs can charge between borrowing and lending rates. Due to some banks looking to get around lending caps by increasing arrangement fees and other costs to the borrower, governments have often tried to limit the total price of the loan.

Other governments have attempted to set different caps for different forms of lending instrument. For example in South Africa, the National Credit Act (2005) identified eight sub-categories of loan, each with their own prescribed maximum interest rate.

Sub-sector	Maximum prescribed interest rate	
Mortgages	$(RR \times 2.2) + 5\%$	per annum
Credit facilities	$(RR \times 2.2) + 10\%$	per annum
Unsecured credit transactions	$(RR \times 2.2) + 20\%$	per annum
Developmental credit agreements		
- for the development of a small business	$(RR \times 2.2) + 20\%$	per annum
- for low income housing (unsecured)	$(RR \times 2.2) + 20\%$	per annum
Short term transactions	5%	per month
Other credit agreements	$(RR \times 2.2) + 10\%$	per annum
Incidental credit agreements	2%	per month

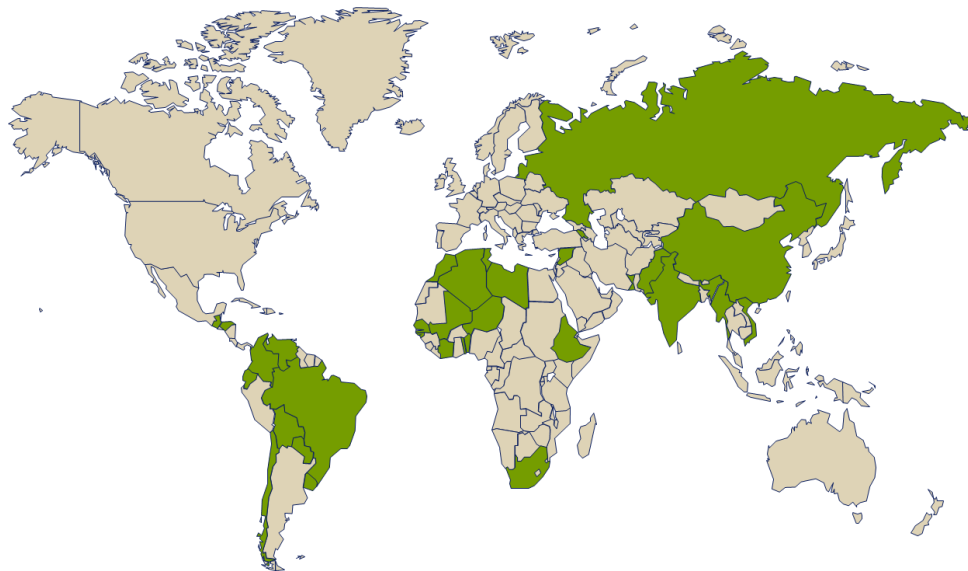
Where RR indicates the central bank repo rate.

A large number of countries now use some form of maximum level of interest rates, including many wealthy countries such as France, Germany and the USA. These caps generally target loan sharks and predatory lending practices and have increased in popularity since the onset of the financial crisis and the growth of payday loan companies. There is an interesting and growing literature around this phenomenon, however for the sake of this study we focus on poorer countries where there are more practical lessons to be learned from studying interest rate controls.

⁸ Bank of Zambia press release, available here <http://www.boz.zm/publishing/Speeches/Press%20Release%20on%20Interest%20Rates.pdf>

Equally, due to the variety of ways in which countries can implement some form of interest cap outlined above, it is difficult to develop a comprehensive list of who is and who is not capping interest rates. Many countries are currently using, or have recently used, some form of a cap to direct resources towards a certain sector or industry, many of which are short term measures and all of which would be very difficult to catalogue. For this reason we provide an indicative list of interest rate ceilings in developing and transition countries that the World Bank put together in 2004 and then focus our attention on a range of case studies.

Figure 5: Interest rate caps in operation in 2004⁹



After the wave of financial liberalisation in the 1990s, the first decade of the 21st century saw a general trend towards greater government control of financial sectors. This was nowhere more true than in Latin America where a number of governments introduced some form of interest rate controls in the past decade. Countries such as Chile, Bolivia, Colombia, Peru, Uruguay, Venezuela, Nicaragua, Guatemala, Ecuador and Brazil all experimented with some form of interest rate control in the past decade.

Many countries in North Africa have used interest rate caps in recent years with Morocco, Tunisia, Algeria, Libya and Egypt using them mainly in the microfinance sector. Ceilings in this region are typically around 3-5% per month.¹⁰ In West Africa, the member states of the then UMOA previously signed up to a limit of 27% per annum for microloans.

An interest rate cap has been in place in India since 2011 where there is a margin cap of 12% and microloans are capped at 26% per annum to support rural households with annual income up to 60,000 rupees and urban and semi-urban households with income up to 120,000 rupees. Similar caps are used across South Asia; in Bangladesh, for example, microloans are capped at 27% per annum to support rural borrowers and the agricultural sector.

⁹ Helms, Brigit and Reille, Xavier, Interest Rate Ceilings and Microfinance: The Story So Far (September 2004) CGAP Occasional Paper no. 9

¹⁰ Allaire, V., Ashta, A., Attuel-Mendes, L. and Krishnaswamy, K., Institutional Analysis to explain the Success of Moroccan Microfinance Institutions (2009) CEB Working Paper N° 09/057

3 The impact of interest caps

3.1 Supply side

Financial outreach

The major argument used against the capping of interest rates is that they distort the market and prevent financial institutions from offering loan products to those at the lower end of the market that have no alternative access to credit. This runs counter to the financial outreach agenda that is prevalent in many poor countries today. The debate can be boiled down to the prioritisation of cost of credit over access to credit.

A randomised experiment in Sri Lanka¹¹ found the average real return to capital for microenterprises to be 5.7% *per month*, well above the typical interest rate of between 2-3% that was provided by MFIs. Similarly, the same authors found in Mexico¹² that returns to capital were an estimated 20-33% per month, up to five times higher than market interest rates.

MFIs have historically been able to expand outreach rapidly by funding network expansion by profits from existing borrowers, meaning that existing clients are in effect subsidising outreach to new areas. Capping interest rates can hinder this process as MFIs may remain profitable in existing markets but cut investment in new markets. At the extreme, government action on interest rates can cause existing networks to retract. In Nicaragua¹³, government introduced the Microfinance Association Law in 2001 which limited microloan interest to the average of rates set by the banking system. After much wrangling the government went even further and attempted to legislate for widespread debt forgiveness. In response to perceived persecution by government, a number of MFIs and commercial banks withdrew from certain areas hindering the outreach of the financial sector.

There is also some evidence to suggest that a cap on lending rates for licensed MFIs incentives NGO-MFIs and other sources of finance for the poor to stay outside of the regulatory system. In Bolivia, the imposition of a lending cap led to a notable fall in the licensing of new entities¹⁴. Keeping lenders out of the system should be unattractive to governments as it increases the potential for predatory lending and lack of consumer protection.

Price rises

There is some evidence from developed markets that the imposition of price caps could in fact *increase* the level of interest rates.

In a study of payday loans in Colorado¹⁵, the imposition of a price ceiling was initially seen to reduce interest rates but over the longer term rates were seen to steadily rise towards the interest rate cap. This was explained by implicit collusion, by which the price cap set a focal point so that lenders knew that the extent of price rises would be limited and hence collusive behaviour had a limited natural outcome.

3.2 Demand side

Elasticity of demand

Inherent in any argument for an upper limit on interest rates is an assumption that demand for credit is price inelastic. If the inverse were true, and that market demand was highly sensitive to small rises in lending rates then there would be minimal reason for government or regulators to intervene.

¹¹ De Mel, Suresh, McKenzie, David John and Woodruff, Christopher M., *Returns to Capital in Microenterprises: Evidence from a Field Experiment* (May 1, 2007). World Bank Policy Research Working Paper No. 4230

¹² McKenzie, David John and Woodruff, Christopher M., *Experimental Evidence on Returns to Capital and Access to Finance in Mexico* (March 2008)

¹³ Campion, Anita, Ekka, Rashmi Kiran and Wenner, Mark, *Interest Rates and Implications for Microfinance in Latin America and the Caribbean*, IADB (March 2012)

¹⁴ *ibid*

¹⁵ DeYoung, Robert and Phillips, Ronnie J., *Payday Loan Pricing* (2009)

Karlan and Zinman¹⁶ carried out a randomised control trial in South Africa to test the received wisdom that the poor are relatively non-sensitive to interest rates. They found that, around the lender's standard rates, elasticities of demand rose sharply meaning that even a small increase in interest rates would lead to a significant fall in the demand for credit. If the poor are indeed this responsive to changes in the interest rate, then it suggests that usurious lending practice would not be commercially sustainable and hence there is little need for government to cap interest rates.

Borrower trends

The chain behind implementing an interest cap runs that the cap will have an effect on the wider economy through its impact on consumer and business activities. The key question to be addressed by any cap is whether it bites and therefore impacts borrower behaviour at the margin.

In South Africa, the National Credit Act was introduced in 2005 to protect consumers and to guard against reckless lending practices by financial institutions. As outlined in section two, it was a variable cap that discriminated between eight different types of lending instrument in order to ensure that the cap can bite at different levels. In one survey of consumers¹⁷

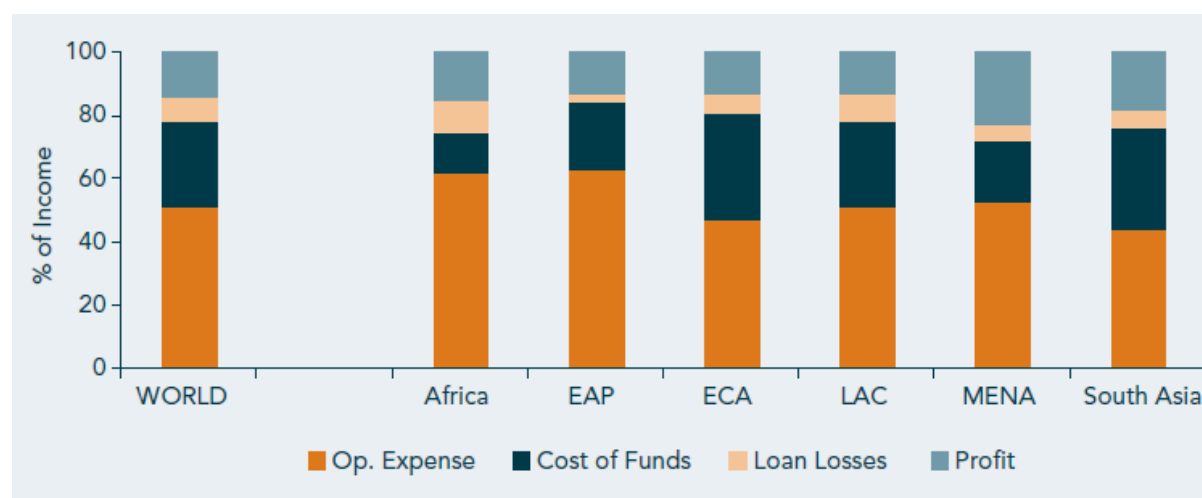
Credit constraints and productivity

An interest cap exacerbates the problem of adverse selection as it restricts lenders' ability to price discriminate and means that some enterprises that might have received more expensive credit for riskier business ventures will not receive funding. There has been some attempt to link this constraint in the availability of credit to output. In Bangladesh¹⁸, firms with access to credit were found to be more efficient than firms with a credit constraint. The World Bank¹⁹ found that credit constraints may reduce profit margins by up to 13.6% per year.

3.3 Are interest rates too high?

A detailed study by CGAP in 2009²⁰ looked in detail at the four elements of loan pricing for MFIs and attempted to measure whether the poor were indeed being exploited by excessively high interest rates. The following table, taken from their report, breaks down the cost structure of MFIs across different regions in 2006.

Figure 6: Cost structures of MFIs by region²¹



¹⁶ Karlan, Dean S. and Zinman, Jonathan, *Credit Elasticities in Less-Developed Economies: Implications for Microfinance* (December 2006)

¹⁷ Mlandu, Nobambo, *The Effectiveness of the NCA in Curbing Consumer Indebtedness* (2007)

¹⁸ Baqui Khalily, M.A. and Khaleque, M.A., *Access to Credit and Productivity of Enterprises in Bangladesh: Is There Causality?* (2012)

¹⁹ Khandker, Shahidur R., Samad, Hussain A. and Ali, Rubaba, *Does Access to Finance Matter in Microenterprise Growth? Evidence from Bangladesh* (January 2013) World Bank Policy Research Working Paper no. 6333

²⁰ Rosenberg, Richard, Gonzalez, Adrian and Narian, Sushma, *The New Moneylenders: Are the Poor Being Exploited by High Microcredit Interest Rates?* (February 2009)

²¹ *ibid*

While these data are interesting for international comparison, they tell us relatively little about efficiency of individual companies and markets. However they do provide some interesting and positive conclusions. For example, the ratio of operating expenses to total loan portfolio declined from 15.6% in 2003 to 12.7% in 2006, a trend likely to have been driven by the twin factors of competition and learning by doing²².

Regarding profitability there is some evidence of MFIs generating very high profits from microfinance clients. The most famous case was the IPO of Compartamos, a Mexican microfinance organisation that generated millions of dollars in profit for its shareholders. Compartamos had been accused of usury, charging clients annualised rates in excess of 85%. The CGAP study found that the most profitable ten percent of MFIs globally were making returns on equity in excess of 35%.

While the international comparison is interesting, it also has practical implications. It provides policymakers with a conceptual framework with which to assess the appropriateness of intervention in credit markets. The question that policymakers must answer if they are to justify interfering in the market and capping interest rates is whether excessive profits or bloated overheads are pushing interest rates to a higher rate than their natural level. This is a subjective regulatory question, and the aim of a policy framework should be to ensure sufficient contestability to keep profits in check before the need for intervention arises.

²² *ibid*

4 Alternative methods of reducing interest rate spreads

From an economic perspective, input based solutions like interest rate caps or subsidies distort the market and hence it would better to let the market determine the interest rate, and to support certain desirable sectors through other means (such as output based aid). Indeed there are a number of other methods available that can contribute to a reduction in interest rates.

In the short term, soft pressure can be an effective tool – as banks and MFIs need licenses to operate, they are often receptive to influence from the central bank or regulatory authority. However to truly bring down interest rates sustainably, governments need to build a business and regulatory environment and support structures that encourage the supply of financial services at lower cost and hence push the supply curve to the right.

4.1 Market structure

The paradigm of classical economics runs that competition between financial institutions should force them to compete on the price of loans that they provide and hence bring down interest rates. Competitive forces can certainly play a role in forcing lenders to either improve efficiency in order to bring down overheads, or to cut profit margins. In a survey of MFI managers in Latin America and the Caribbean²³, competition was cited as the largest factor determining the interest rate that they charged. The macro evidence supports this view – Latin countries with the most competitive microfinance industries, such as Bolivia and Peru, generally have the lowest interest rates.

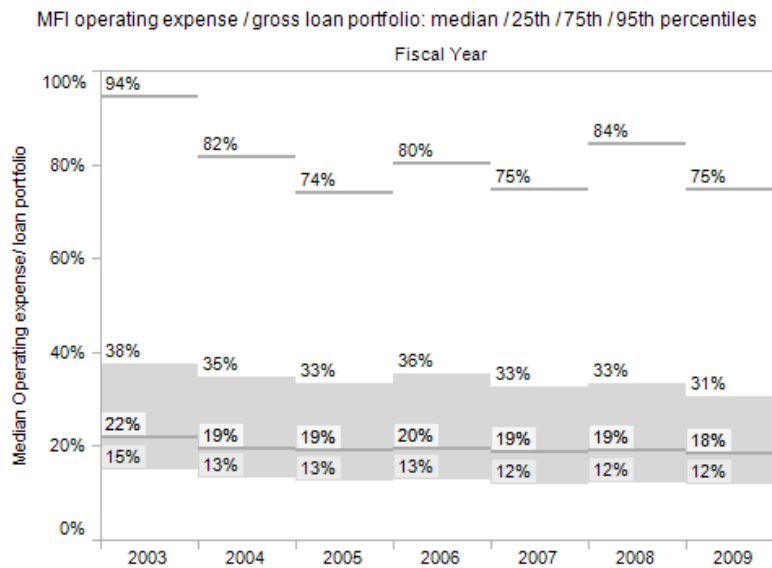
The corollary of this, and the orthodox view, would seem to be that governments should license more financial institutions to promote competition and drive down rates. However it is not certain that more players means greater competition. Due to the nature of the financial sector, with high fixed costs and capital requirements, smaller players might be forced to levy higher rates in order to remain profitable. Weak businesses that are inefficiently run will not necessarily add value to an industry and government support can often be misdirected to supporting bad businesses. Governments should be willing to adapt and base policy on a thorough analysis of the market structure, with the promotion of competition, and the removal of unnecessary barriers to entry such as excessive red tape, as a goal.

4.2 Market information

The evidence suggests that learning by doing is a key factor in building up efficiency and hence lowering overheads and hence interest rates. Institutions with a decent track record are better able to control costs and more efficient at evaluating loans while a larger loan book will generate economies of scale. More established businesses should also be able to renegotiate and source cheaper funds, again bringing down costs. In China, the government supports the financial sector by setting a ceiling on deposits and a floor on lending rates meaning that banks are able to sustain a minimum level of margin. Following an international sample of MFIs, there is clear evidence from the Microfinance Information Exchange²⁴ (MIX) that operating expenses fell as a proportion of gross loan portfolio as businesses matured.

²³ Campion, Anita, Ekka, Rashmi Kiran and Wenner, Mark, *Interest Rates and Implications for Microfinance in Latin America and the Caribbean*, IADB (March 2012)

²⁴ <http://www.themix.org/publications/microbanking-bulletin/2011/05/microfinance-efficiency>

Figure 7: MFI operating expenses as a proportion of gross loan portfolio²⁵

The implication of this is that governments would be better off addressing the cost structures of financial institutions to allow them to remain commercially sustainable in the longer term. For example, government investment in credit reference bureaus and collateral agencies decreases the costs of loan appraisal for banks and MFIs. Supporting product innovation, for example through the use of a financial sector challenge fund, can bring down the cost of outreach and government support for research and advocacy can lead to the development of demand-led products and services. The FinMark Trust is an example of donor funds supporting the development of research and analysis as a tool for influencing policy.

4.3 Demand side support

Government can help to push down interest rates by promoting transparency and financial consumer protection. Investment in financial literacy can strengthen the voice of the borrower and protect against possible exploitation. Forcing regulated financial institutions to be transparent in their lending practices means that consumers are protected from hidden costs. Government can publish and advertise lending rates of competing banks to increase competition. Any demand side work is likely to have a long lead time to impact but it is vital that even if the supply curve does shift to the right that the demand curve follows it.

²⁵ ibid

5 Conclusion

There are situations when an interest rate cap may be a good policy decision for governments. Where insufficient credit is being provided to a particular industry that is of strategic importance to the economy, interest rate caps can be a short term solution. While often used for political rather than economic purposes, they can help to kick start a sector or incubate it from market forces for a period of time until it is commercially sustainable without government support. They can also promote fairness – as long as a cap is set at a high enough level to allow for profitable lending for efficient financial institutions to SMEs, it can protect consumers from usury without significantly impacting outreach. Additionally, financial outreach is not an end in itself and greater economic and social impact might result from cheaper credit in certain sectors rather than greater outreach. Where lenders are known to be very profitable then it might be possible to force them to lend at lower rates in the knowledge that the costs can be absorbed into their profit margins. Caps on interest rates also protect against usurious lending practices and can be used to guard against the exploitation of vulnerable members of society.

However, although there are undoubtedly market failures in credit markets, and government does have a role in managing these market failures (and indeed supporting certain sectors), interest rate caps are ultimately an inefficient way of reaching the goal of lower long term interest rates. This is because they address the symptom, not the cause of financial market failures. In order to bring down rates sustainably, it is likely that governments will need to act more systemically, addressing issues in market information and market structure and on the demand side and ultimately supporting a deeper level of financial sector reform.

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Two experiences with interest rate caps “ in Kenya and Zambia “ demonstrate the power of political forces to shape financial inclusion policies and may hold lessons for MSME lenders in other countries. In a recent unpublished study, the Partnership for Responsible Financial Inclusion (formerly the Microfinance CEO Working Group) examined commonalities in the origins of interest rate caps in these two countries. In 2013, the interest rate caps were also imposed on microfinance lending. The maximum rate was set at 42 percent for a select group of microfinance institutions and 30 percent for other non-bank financial institutions. Following Sata’s death in 2014 and the election of his replacement, the interest rate caps were removed in 2015.