Exploitative Microfinance Interest Rates

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Abstract

The field of microfinance emerged in the developing world as a vehicle to provide financial services to poor segments of population is gradually being seen as a profitable business opportunity. In the initial stages of development, these activities were perceived to be done with a service agenda. As the micro finance institutions (MFIs) began to mature, they started facing performance dilemma, and focus is gradually shifted towards profitability.

In order to improve profitability of MFI, interest rate on loan is kept at a very high level and additional costs in the form of margin money, compulsory savings and insurance premium are being imposed to borrowers. Majority of MFI borrowers are poor and illiterate and they are not expected to understand and realise various financial jargons used by MFIs and their effective cost.

To help poor to understand true cost of loan MFI should disclose effective interest rate to the borrowers. Hiding effective interest rate to poor and illiterate borrowers by using "creative" accounting practices is highly unethical. Many MFIs simply state that they charge only 15% flat rate of interest. But the effective interest rate including processing fee, compulsory savings, etc goes well over 100% per annum.

Keywords: Microfinance institutions, Interest rate

JEL Classification:

G21 - Banks; Other Depository Institutions; Micro Finance Institutions; Mortgages

E43 - Determination of Interest Rates; Term Structure of Interest Rates

1. Introduction

Microfinance is defined as the provision of credit, savings, and financial services to very poor people. Providing these services to very poor households offers opportunities for the poor to create, own, and accumulate assets and to smooth consumption. (CGAP 1998). In absence of banking facility, the poor often resorts money lending from relatives and acquaintances but when such sources are not available they approach local moneylenders. Moneylenders can and do provide very flexible and fast service tailor-made to the needs of the borrowers but they are often accused to charge exorbitant interest rates.   Here the field of microfinance comes to the help of the poor. The microfinance institutions (MFIs) are supposed to meet financial requirements of poor at a low cost. The area of microfinance was pioneered by specialized NGOs and commercial banks such as Grameen Bank of Bangladesh headed by Mohammad Yunus among others.

Microfinance has travelled a long journey and has been providing microfinance loans exceeding several billions of dollars. But the original idea of service to the poor is getting replaced by profiteering concepts like IPO, ROE, Securitisation, etc. Muhammad Yunus himself has expressed his dissatisfaction for the growing commercialisation of microfinance. In an interview with CNNMoney.Com, Yunus criticised those involved with for-profit microfinance by saying that "poor people should not be considered an opportunity to make profit." He believes that the profit maximisation motive of commercial microfinance is a distortion and Microfinance should avoid capital markets to retain it's not for profit ideology. MFI to remain viable may charge cost of borrowing and few extra percentages just to cover the operating expenses. Those who charge more than 15% over cost of funds have "just left the micro-credit area and joined the loan-shark area".

Grameen Bank of Bangladesh charges an annual interest rate of 20% and made a small profit in the year 2007, but here the profits eventually benefits the poor as 90% shares of the bank are owned by the borrowers and remaining 10% lies with Government.

Conceiving it as a business opportunity, microfinance has started attracting investors focused solely on financial returns. Large investment firms like, Citigroup, Morgan Stanley, Merrill Lynch, Deutsche Bank, ICICI Bank, etc. have started investing in microfinance due to its stable returns, low default rates, and portfolio diversification opportunity.

The high interest rates charged by for profit microfinance institutions are drawing attention of policy makers throughout the world. Several concerns have been raised, such as, why do institutions that set out to help the poor charge such high rates and earns profit from poor. Should poor people have to pay for high MFI costs incurred by MFIs due to their inefficiencies? According to The Consultative Group to Assist the Poorest (CGAP), Governments of about 40 developing countries have fixed some kind of mandatory interest rate ceilings to address this kind of concern (CGAP 2004a, CGAP 2004b).

2. Justification of commercialisation of microfinance

The provision of financial services to the poor is obviously a difficult task because the poor usually live in remote and inaccessible places without basic infrastructure. It is not only difficult to make personal contact with these remotely located poor but such contacts are also expensive. It is well argued in micro-finance literature that unless the cost of microfinance operation is passed on to the borrowers, the institutions will fail to be sustainable.

An Asian Development Bank note justifies charging high interest rates on account of higher cost of services incurred by the MFI. It argues that interest charged on loans is the main source of income for these institutions and, because they incur huge costs, the rates are correspondingly high (Fernando, 2006).

Following arguments are generally put forth in support of high interest rates (CGAP 2002a, CGAP 2002b, Fernando 2006, Dehejia et al 2005)

• Interest rates charged by money lenders are overwhelmingly higher than MFI rates. Money lenders charge an interest rate of over 10% per month. A standard money lending loan in the Philippines is the "5/6 loan" – for every five persons borrowed in the morning, six must be repaid in the evening. This amounts to a daily interest rate of 20%.

• Poor borrowers/entrepreneur can generate greater benefit from additional units of capital than a highly capitalised business can. A vegetable vendor in India can buy vegetables from a wholesaler at Rs.2 per kg and sell the same to retail customers at Rs.12 per kg, earning 500% income a day!

• For a poor micro entrepreneur, the cost of micro credit loan represents a small portion of her total business cost. A Rs.1000 micro loan repayable in 3 months with 6% interest per month, calculated on a declining balance, costs a client only Rs.122, which is a very tiny amount as a percentage of her total costs.

• When women SHG members lend to each other, they can lend on whatever terms they wish. When such arrangement prevails, the women commonly charge each other an interest rate that is substantially higher than what MFI charges to its borrowers.

• MFIs charging very high interest rates almost always find that demand for loans outstrips their ability to supply it. Many poor people take repeated loans. This demonstrates that loans allow them to earn more than the interest they have to pay.

• There is a vast amount of literature on the Internet consisting mainly of conference proceedings and discussion groups. It advocates charging market based (high) interest rate. There are no instances that a microfinance programme ran into trouble by driving away clients with interest rates that are too high.

• Range of investment opportunity available to rural poor is endless. When a poor woman receives Rs.1000/- loan, she will look through her range of investment possibilities and spend her money on the one that offers highest rate of return (for example, vegetable selling can yield 500% returns in a day). A large corporate house cannot pay as high an interest rate as a poor micro entrepreneur, because they already have a lot of capital and have already "used up" most of the profitable investment options available to it. A micro entrepreneur on the other hand can derive greater relative benefit from additional units of capital, simply because she has so little capital. So she can pay a higher interest rate and still come out ahead.

• The access to finance to poor is a much more important issue than the cost of finance. When a poor women needs Rs. 1000/- for treatment of her ailing son, the timely availability of credit alone is important for her, not the interest rate.

• When poor are willing to pay high interest rates to MFI loan, why talk about high interest rates? Any cap on interest rates is likely to be detrimental for the growth of MFI and neither will it be in the interest of the poor.

3. Should there be any interest cap?

High interest rates charged by MFIs have attracted criticism from government and opposition leaders in many countries including India. In March 2006 district authorities closed down about 50 branches of two major MFIs in Krishna district of Andhra Pradesh (India). Some borrowers complained to the district authorities that these MFIs are charging "usurious interest rate" from the poor borrowers and also using "forced loan recovery" practices. The crisis has attracted the attention of both local and national media. The local media, especially, carried many stories which were highly critical of the role played by MFIs.

The issue also came up before the State Level Bankers' Committee (SLBC) meet held on March 17, 2006. The chief minister (CM) of AP who chaired the meet took a tough stand against the MFIs by alleging that they are exploiting the poor by charging exorbitant rates of interest and adopting unethical means of loan recovery. He expressed the view, "MFIs were turning out to be worse than moneylenders by charging interest rates in excess of 20 per cent" (*The Hindu*, March 18, 2006). Further to the development, there was even an allegation that 10 borrowers of MFIs in Krishna district committed suicide because they were unable to repay the loans taken from MFIs. There were three major allegations against the MFIs that came up during the crisis (Shylendra 2006).

• MFIs are charging exorbitant rates of interest. Not only that MFIs charge absolutely high interest rate (upwards of 20 per cent), but their practices like forced savings, applying a flat rate method and adding service and other charges, over and above the annual interest rate, further exacerbate the cost. This is leading to an overall high cost of borrowing for the poor, making MFIs' rates look almost usurious. Further, MFIs lack transparency with regard to their interest rate practices, which is helping them to transfer various   costs on to gullible borrowers;

• MFIs are resorting to unethical ways of recovering loans by confiscating title deeds, using intimidation and abusive language, and combining multiple products like savings, insurance and loan to ensure prompt recovery; and

• MFIs are aggressively poaching from government and banks to capture their borrowers. They are luring the members of government supported self Help Groups by liberally financing them, leading to multiple financing.

Because of such practices, it is argued that MFIs are causing a huge burden on the poor, leading to a vicious cycle of debt, poverty and even deaths (Kumar 2006). Though there is no clear evidence to prove these allegations against the MFIs in AP; there is however some evidence from studies carried out elsewhere, which indicate that these allegations are to some extent true about MFIs in general (Mitra 2005; Rhyne 2001; Shylendra 2006; Sinha and Matin1998).

4. True Cost of MFI Loan

The actual interest that a borrower pays to MFI is determined not only by the stated interest rate but also the method used to calculate repayment instalment. Many MFI explain to the borrower that they charge a mere 15% to 20% flat rate of interest per annum. It is common practice of MFI to hide actual interest cost by various creative accounting practices. Effective interest rates are many times higher than the stated interest rate on account of following:

• Use of flat rates of interest

• Collection of security deposit (deducted from the loan amount)

• Compulsory   savings collected with loan instalments

• Charging insurance premium for the loan

• High penalty for missing a repayment schedule, etc.

4.1 Use of Flat Rates of Interest

When flat rate of interest method is used, the interest is charged on the original face value of loan for the entire period of loan.   Though the balance loan amount of the micro finance borrower reduces with each weekly instalment payment, the borrowers are made to pay interest on full sanctioned amount. Let us have a look on how much interest is charged by an MFI with a stated 15% flat rate of interest per annum. Consider a simple example of a Rs. 3000/- loan given at a flat rate of 15% interest per annum repayable at 12 monthly instalments at the end of each month. The monthly repayment schedule is given in Table-1 and Table-2.

It can be seen from the table-2 that principal outstanding at the beginning of month-1 is Rs.3000 and interest for the month is Rs. 37.50. Thus the annualised rate of interest for month-1 works out to $\frac{Rs.37.50}{Rs.3000} x12 (months/year) = 15\%$ per annum. As the part of the principal is repaid in each month, the loan outstanding reduces after each instalment. For example in month-2, the principal outstanding is Rs 2750 (as Rs.250 is repaid at the end of month-1). The annualised rate of interest for month-2 works out to $\frac{Rs.37.50}{Rs.2750} x12 = 16\%$ per annum.

If we compare interest rate paid in the 12th month, when principal outstanding is only Rs.250, the annualised rate of interest for month-12 works out to $\dfrac{Rs.37.50}{Rs.250} x12$ = 180% per annum.

Thus for a stated interest rate of only 15% per annum flat rate, the borrower pay effective interest of 15% to 180% per annum. The word "Flat" is the key word and many microfinance borrowers being illiterate do not understand the dubious meaning of flat rate of interest that they are paying.

The effective rate of interest for the above repayment schedule works out using the following financial argument

$$pv*(1+r)^n + i\left(\dfrac{(1+r)^n - 1}{r}\right) + fv = 0 \qquad \ldots \text{(Equation-1)}$$

Where

- r = effective interest rate per period
- pv = the net amount given to borrower.
- i = actual amount repaid in each periodical instalment.
- n = total number of repayment periods
- fv = amount paid to the client at the end of the loan period. This is return of security deposit with interest or return of the accumulated savings.

The effective interest rate (r) of the repayment table-2 works out to 2.22% per month. On a monthly compounded basis the annual rate of interest works out to $(1+0.0222)^{12} - 1$ = 0.3012 or 30.12% per annum.

4.2 Collection of Security Deposit

Though MFIs are not allowed to accept savings from the public, many MFIs adopt dubious ways to deduct savings from the loan disbursement in various names like Security Deposit, Margin money, etc. This compulsory deduction can range anything from 0% to 20% at the discretion of MFI. Lenders propagate that this deduction is to promote savings habit of the poor and the amount is returned with interest at the end of the loan period.

Let us find out the interest rate applicable to poor micro borrower when such security deposit is compulsorily deducted. We will rework the previous example with following changes.

- Loan sanctioned : Rs. 3000
- Security Deposit : 20% of loan = Rs. 600
- Actual amount paid to the lender at the time of loan disbursement : Rs. 2400
- Interest on security deposit : 5%
- Security deposit refunded with 5% interest after one year : Rs. 630
- Other loan terms remain unchanged i.e. the entire loan is to be repaid by 12 monthly instalments of Rs. 287.50 per month.

The effective rate of interest of the above loan scheduled can be estimated using following parameter values in equation-1.

- pv = Rs. 2400 (the net amount after deduction of security deposit)
- i = Rs. 287.50 per month.
- n = 12
- fv = RS. 630 (security deposit refunded with interest)

The value of effective interest rate per month with security deposit is 3.17% per month, and works out to $(1+0.0317)^{12} - 1$ = 0.4539 or 45.39% per annum.

4.3 Compulsory Savings Collected with Loan Instalments

Many MFIs strongly advocate need for providing regular savings services to microfinance borrowers. So that poor people's tiny savings grow over time, and they may not depend on loan in future. While the stated intention is undoubtedly honest, the financial implication in terms of profitability to the MFI is tremendous. Again consider the

previous example, wherein the client is required to same a tiny amount of Rs. 100/- per month to be paid at the time of making loan repayments. The savings will be refunded to the clients with 5% interest at the end of the loan period. The

savings of Rs. 100 per month @ 5% per annum will grow to $100 * \left[\left(1 + \left(\frac{.05}{12}\right)\right)^{12} - 1 \right] / \left(\frac{.05}{12}\right)$ = Rs. 1227.89 and will

be refunded to the client after the end of the year. The equation-1 can again be used to calculate effective rate of interest with following parameter values.

- *pv* =   Rs. 2400 (the net amount after deduction of security deposit)
- *i* = Rs. 287.50 per month.
- *n* = 12
- *fv* = Rs. 630 + Rs. 1227.89 = Rs 1857.89(security deposit and monthly savings refunded with interest)

The effective interest using the equation-1 now increases to 5% per month and 80% per annum. When savings are made an integral component of the loan, the effective interest rate shoots up. This is primarily due to the reason that the microfinance borrowers are paid a mere 5% interest per annum for their savings, whereas for loan they are charged a very high effective interest rate. A borrower who is forced to save gets a very little cash in hand after deduction of security deposit from the loan disbursement but continues to pay high interest for the entire loan amount. The savings interest is a minuscule amount in comparison to the interest she pays for lending.

5. A real case where effective interest cost is very high

In the example given above, monthly repayments were illustrated but to make things worse, instalments are collected on weekly basis. Let us calculate effective interest rate of an actual product (the product is similar to products offered by a NGO MFI known to the author.

5.1 The Loan

- First loan is between Rs.1000 to Rs.5000
- Interest rate is 17.5% per annum (flat)
- Repayment in weekly instalments; for 47 weeks.
- For a Rs.1000 loan interest for the year is 17.5% of 1000 = 175. The borrower has to refund the same in 47 instalments of 1175/47 = Rs.25 per week.

5.2 Collateral

Since loans are given without any collateral, 10% of the loan is deducted upfront as margin money/security deposit which is refunded with 5% interest at the end of year.

5.3 Savings

Every member deposits Rs.10/- per week and can withdraw after one year with 5% interest on savings.

5.4 Insurance

To mitigate loan loss due to the death of borrowers an insurance premium of 2% is charged, which is deducted upfront from the loan amount.

5.5 Cash Flow

The cash flow of the above scheme is as under:

- Loan sanctioned   Rs.   1000
- Deduction 10% security deposit -Rs.   100
- 2% insurance   -Rs.   20
- Net amount paid to borrower   Rs.   880
- Repayment; 47 weeks   Rs.   25 per week
- Savings;   47 weeks   Rs.   10 per week

Amount paid after 47 weeks is as follows:

- Refund of Security Deposit 5% interest = $100 \left(1 + 0.05\left(\frac{47}{52}\right)\right)$ = Rs. 104.52

- Refund of weekly savings of Rs.10/- for 47 weeks with 5% interest p.a.$= 10 * \left[\left(1 + \left(\frac{.05}{52} \right) \right)^{47} - 1 \right] / \left(\frac{.05}{52} \right) =$ Rs. 480.55

5.6 Effective cost of loan

The effective cost of interest can be obtained by using following parameter values in equation-1.

- pv = Rs.880 (net amount paid to the borrower)

- i =   Rs.35 (Rs.25 for loan & Rs.10 for savings)

- n =   47 (week)

- fv =   Rs.585.06 (Rs.104.52 for security deposit + Rs.480.55 for savings)

The weekly effective rate of interest works out to 1.534% and compounded on weekly basis for 52 weeks (1 year), the annualised rate goes up to 120.67%. The situation become worse when security deposit is deducted @ 20% of loan amount at the time of disbursement and in such cases annualised effective rate of interest goes up to 193.8% per annum (all in the name of savings need for the poor!).

6. Should such high rates be justified?

Objective of microfinance lending should be to genuinely help the poor to come out of poverty and not to make money by lending them at exorbitantly high interest rate. Poor has very little choice and hence demand for loan at high rate will remain; which money lenders were extending from time immemorial. Instead of comparing interest rate offered by money lender, they should compare interest rate of micro lending offered by formal institution like Bank-SHG linkage schemes.

Majority of MFI borrowers are poor and illiterate women, they are not expected to understand and realise various financial jargons and their effective cost. Fancy terms like, membership fees, service charges, flat rate of interest, margin money, savings which earn interest, insurance etc are quite confusing to many of them (if not all). Lending terms should therefore be kept simple for them to understand.

7. Conclusion

The cost of microfinance loan to poor borrowers in India varies anything between 12% p.a. to more than 120% p.a. depending on nature of MFIs that provide service to the poor. MFI should disclose effective interest rate to the borrowers. Hiding effective interest rate to poor and illiterate borrowers by using "creative" accounting practices is highly unethical. Many MFIs simply state that they charge only 15% flat rate of interest. But the effective interest rate including processing fee, compulsory savings, etc goes well over 100% p.a. As a result some of these micro lending outfits breakeven within 6-9 months operations and thereafter their motive are only to earn profits!

Microfinance must not deviate from its original objective of extending a helping hand to the poor and must not be viewed as an opportunity to make money from poor borrowers.

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Table 1. Monthly Instalments

	Total in the Year	Per Month
Principal	Rs. 3000	(3000/12) = Rs. 250
Interest %15 (Flat)	(0.15*3000)= Rs. 450	(450/12) = Rs 37.50
Total (Principal+Interest)	Rs. 3450	Rs 287.50

Table 2. The repayment table for the loan

Month	Principal outstanding at the beginning	Principal repaid per instalment	Interest paid in each instalment	Total amount paid in each instalment	Principal outstanding at the end	Interest as % of principal outstanding
1	3000	250	37.5	287.5	2750	15%
2	2750	250	37.5	287.5	2500	16%
3	2500	250	37.5	287.5	2250	18%
4	2250	250	37.5	287.5	2000	20%
5	2000	250	37.5	287.5	1750	23%
6	1750	250	37.5	287.5	1500	26%
7	1500	250	37.5	287.5	1250	30%
8	1250	250	37.5	287.5	1000	36%
9	1000	250	37.5	287.5	750	45%
10	750	250	37.5	287.5	500	60%
11	500	250	37.5	287.5	250	90%
12	250	250	37.5	287.5	0	180%