Microfinance Needs Regulation
By Aneel Karnani
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The volatile combination of profit-seeking microfinance companies, minimal competition, and vulnerable borrowers has opened up dangerous potential for exploiting the poor. The microcredit industry needs to be regulated—through policies that address transparency, high interest rates, and abusive loan recovery practices.

Since Muhammad Yunus pioneered the concept of microcredit in 1976 and founded the Grameen Bank in Bangladesh, microcredit has become a major movement. Worldwide, 3,552 microcredit institutions provided loans to 155 million clients, finds the State of the Microcredit Summit Campaign Report 2009. Grameen Bank alone disbursed more than $5 billion in microloans over the last 10 years, and it now has 7.7 million borrowers. According to the Grameen Bank website, microcredit is “offered for creating self-employment for income-generating activities and for housing for the poor, as opposed to consumption.” The poor are expected to invest the microloans to start up or grow a microbusiness and thus climb out of poverty. Microcredit is the latest silver bullet for alleviating poverty.

In his popular 2005 book Fortune at the Bottom of the Pyramid, C.K. Prahalad argued that there is much untapped purchasing power at the bottom of the pyramid (BOP), and that private companies can make significant profits by selling to the poor, while simultaneously bringing them prosperity. Focusing on efficiency and low default rates, Prahalad cites microcredit as a good example of the BOP proposition. And indeed, in the past few years hundreds of for-profit companies have begun financing and marketing loans to the poor in developing countries. But, in an ironic twist, private companies are making a fortune in microcredit by doing exactly what microcredit was designed not to do: exploit the poor. “Now poor people are turning into one of the world’s least likely sources of untapped profit, primarily because they will pay interest rates most Americans would consider outrageous, if not usurious,” wrote BusinessWeek journalists Keith Epstein and Geri Smith in a December 2007 article. MFTransparency, a self-monitoring microfinance industry association, finds that private companies have been attracted to microcredit “by near-monopoly lending environments and misleading pricing systems compounded by borrowers’ frequent lack of understanding of the financial details of credit transactions.”

Whether fair or not, a few recent high-profile events have galvanized criticism of microfinance institutions (MFIs). When Banco Compartamos in Mexico went public in April 2007, the initial investors’ stake of $6 million was valued at $1.5 billion—a return of roughly 100 percent a year compounded over eight years. This profitability is due to the fact that

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Illustration by Oliver Munday
Compartamos charges interest rates that exceed 100 percent annually on their loans to the poor. Yunus was particularly critical of Compartamos, telling BusinessWeek, “Microcredit was created to fight the moneylender, not to become the moneylender.”

In the Indian state of Andhra Pradesh more than 200 people committed suicide, allegedly because of intimidation by MFIs. Government authorities closed down 50 branches of two major MFIs in 2006 and charged them with exploiting the poor with usurious interest rates and intimidating the borrowers with forced loan recovery practices. Y.S. Rajasekhara Reddy, chief minister of Andhra Pradesh, was quoted in The Times of India as saying, “MFIs were turning out to be worse than moneylenders by charging interest rates in excess of 20 percent.” And over the past few years, there has been growing criticism of MFIs by government officials and politicians in Bangladesh, Cambodia, India, Pakistan, and Sri Lanka.

I argued in an earlier article in this magazine that microcredit does not significantly alleviate poverty (see “Microfinance Misses Its Mark” in the summer 2007 issue of the Stanford Social Innovation Review). The vast majority of microcredit clients are caught in subsistence activities and compete in overcrowded markets. They usually have no specialized skills, hire no paid staff, own few assets, and operate on too small a scale to achieve efficiencies, and so they do not earn enough to rise out of poverty. In March 2009 the World Bank published Moving Out of Poverty, one of the most thorough field studies of the dynamics of poverty based on narratives from 60,000 poor or formerly poor people in 15 countries of Asia, Africa, and Latin America. The study notes an “important insight” that “the tiny loans usually provided under microcredit schemes do not seem to lift large numbers of people out of poverty.”

Regardless of this debate, microcredit has grown dramatically in the last 30 years and become increasingly commercialized. The volatile combination of profit-seeking companies, minimal competition, and vulnerable, ill-informed, and ill-educated borrowers has opened up dangerous potential for exploiting the poor. There is a dire and immediate need to regulate microcredit to protect poor borrowers.

**DENY THE PROBLEM**

One response of the microcredit industry to mounting criticism has been to deny the problem. In a June 2008 open letter to critics, Carlos Danel and Carlos Labarthe, the co-founders of Compartamos, write, “In an open and free market, we are convinced our clients are in the best position to make the right choices for themselves and their families.” The first problem with this assumption is that the microcredit organizations do not operate in free and competitive markets. They are actually often quasi-monopolies. The Consultative Group to Assist the Poor (CGAP), a consortium of development agencies and private foundations dedicated to promoting microcredit, states, “In most countries, the microcredit market is still immature, with low penetration of the potential clientele by MFIs and little competition so far.” Nimal Fernando, a microfinance specialist working for the Asian Development Bank, concurs: “In many countries in the region [Asia], the majority of microcredit is provided by a few leading institutions, and competition among them is mostly on non-price terms.”

Later in their open letter, Danel and Labarthe concede that microcredit is not a competitive market. They justify their bank’s high interest rates and high profitability on the grounds that they “wanted to build an industry … to draw in investors and competition.” The promise is that “competition will make for more and better products at better prices in the future.” This is a rather disingenuous defense of exploiting the poor. Let’s follow the argument: Exploitation today will enable future competition that will then reduce exploitation. (So the monopolists exploiting the poor today are doing a service for tomorrow’s consumers.) By this logic, we should be grateful to the loan sharks of past centuries for charging usurious interest rates that have attracted microcredit firms to the market.

The second and bigger problem with the free market argument is the assumption that microcredit clients are rational economic actors. Even in a rich country like the United States, there are laws to protect financial services customers. Since the 2008 economic crisis, there has been a strong push by the Obama administration to increase consumer protection with, for example, the Credit Card Accountability Responsibility and Disclosure Act of 2009. The Obama administration in July 2010 created an independent agency, the Consumer Financial Protection Bureau, with broad authority to protect consumers of financial services from abusive, deceptive, and unfair practices. The administration justified regulatory reform on the grounds that “financial products are complex, and it is often difficult for even the most financially astute consumers to recognize the risks financial products can present.” If financial literacy is a problem in the United States, it is a much bigger problem for microcredit clients in poor countries. In fact, poor people are often illiterate and innumerate. The adult illiteracy rate in India is 39 percent, and clearly much higher among the poor. This problem is exacerbated for microcredit clients who are overwhelmingly female and have an even higher illiteracy rate.

There are very few empirical studies on financial literacy, especially in developing countries. A survey of clients of two microfinance organizations in India found, not surprisingly, very low levels of financial literacy. The great majority of the respondents could not identify the interest rates on their loans (due in part to a lack of transparency, which I will discuss below). The survey also found that only 17 percent of the respondents were able to solve the arithmetic problem “divide 8,000 by 10,” and only 3 percent of respondents could solve the problem “multiply 4,500 by 18.” Given such low levels of numeracy, it is difficult to see how microcredit clients can make good financial choices, such as comparing two loans with different terms.

The microcredit industry has tried to downplay the problem of consumer exploitation. In a February 2009 paper CGAP argues, “It is a mistake to assume that Compartamos’ interest rates are typical of the industry, or even a substantial part of the industry.” But should we wait until exploitation has become pervasive before implementing consumer protection regulation? There are laws against stealing, even though most people are not thieves. In developed countries there are laws regulating loan recovery process, even though abusive practices are not widespread. Moreover, high interest rates are not as rare as...
CGAP implies. By their own analysis, 5 percent of microcredit loans worldwide are at interest rates higher than 50 percent per year; and this does not take into account fees and compulsory savings that significantly increase the effective interest rates. Lack of transparency is almost universal. Chuck Waterfield, microfinance expert and founder of MF Transparency, argues that the true price of microcredit loans has “never been accurately measured nor reported. ... This is hard to imagine and even harder to explain.” Regulation of the microcredit industry must focus on three issues: lack of transparency, high interest rates, and abusive loan recovery practices.

LACK OF TRANSPARENCY
At a Microcredit Summit Campaign conference in July 2008, MF Transparency was launched as the industry’s policeman. Since then, 183 industry leaders have endorsed the organization. On its website, MF Transparency states its reason for forming: “Due to complications of market conditions and lack of regulation, the true price of loan products has never been accurately measured or reported.” MF Transparency’s phrase “complications of market conditions,” however, seems to be a euphemism for market failure.

The effective interest rate that a borrower pays for microcredit is very different from the stated interest rate of the loan. Microcredit organizations routinely hide the actual interest cost by using “creative” practices, such as charging interest on the original value of the loan rather than on the declining balance; up-front fees; collection of a security deposit (deducted from the loan amount); compulsory savings (collected with loan installments); and charging an insurance premium. With such hidden charges it is common for the effective annual interest rate to be more than 100 percent, when the stated interest rate is only 15 percent.

Subrata Mitra, finance professor at the Indian Institute of Management Calcutta, describes a typical Indian MFI loan of 1,000 rupees (Rs) with an annual interest rate of 17.5 percent due in 47 weekly installments. The total repayment would be 1,175 Rs at 25 Rs per week. But there would also be a security deposit of 10 percent of the loan deducted up front and refunded with 5 percent interest at the end of the year, as well as an insurance premium of 2 percent deducted up front. The borrower would also be required to save 10 Rs per week for one year at 5 percent interest rate.10 With these terms, the effective annualized interest rate is 121 percent compared to the stated interest rate of 17.5 percent. Given the low levels of numeracy and literacy, let alone financial literacy, it is impossible for microcredit clients to compare two loan products with a plethora of confusing terms.

The 2009 book Portfolios of the Poor applauds MFIs for charging up-front fees as a way to reduce risk. In fact, up-front fees and the other complicated terms serve only to reduce the effective amount of the loan and to increase the effective interest rate charged, which increases the MFI’s profits but does no good for the poor. It is ironic that the savings feature of microcredit loans is touted as serving the poor’s savings needs. The poor clearly need savings facilities, but bundling together savings with microcredit in a non-transparent manner is ineffective and unethical. If the security deposit is increased to 20 percent in the loan example above, the effective interest rate jumps to 194 percent per year.

An essential condition for an open and free market is the ability to compare competing products, which requires pricing transparency. Regulation is needed that mandates microcredit organizations to explicitly state the effective interest rate calculated using a standard and prescribed approach, and to describe all the loan terms simply.

HIGH INTEREST RATES
Criticism of the microcredit industry for charging high interest rates has intensified in recent years, especially with the growth of for-profit MFIs. A paper published by CGAP argues, “It is fair to criticize an MFI’s interest rates as unreasonable only if its profits or some controllable element of its costs is unreasonable.”11 This is happening: Interest rates, profits, and controllable costs are unreasonably high for a significant part of the microcredit industry—and the need to regulate an interest rate cap for microcredit is imperative.

Based on data from 555 sustainable MFIs in 2006, the above CGAP paper shows that the median interest rate is 28 percent per year. Even this number is understated because it does not include the impact of compulsory savings, which increases the effective cost of the loan to the borrower. Yunus argued in 2009 that if the microcredit interest rate is more than 15 percent above the cost of funds, then it is “too high... You are moving into the loan shark zone.” Generously allowing 10 percent for cost of funds implies that more than half of MFIs charge interest rates that Yunus would consider too high. In Sub-Saharan Africa and Latin America, 5 percent of MFIs charge interest rates above 70 percent; around the world, 5 percent of MFIs charge interest rates above 50 percent per year. Although Compartamos’ interest rates exceeding 100 percent might be exceptional, interest rates exceeding 50 percent are certainly not rare.

Many MFIs are very profitable. In the CGAP study, MFIs earned 2.1 percent return on assets annually, which is well above the 1.4 percent earned by banks in the same countries. MFIs are usually not as highly leveraged as banks, thus lowering their return on equity. In spite of this, 10 percent of worldwide microcredit loans earned return on equity above 35 percent in 2006. These are high profits by any business criteria. The CGAP study concludes that MFI profits are high because “the microcredit market is still immature, with low penetration of the potential clientele by MFIs and little competition so far.” Monopoly rents and vulnerable consumers are the cause of high prices and profits in microcredit.

The industry response is that the high interest rates are due not to high profits but to high costs. Because of fixed costs in servicing a loan, it is proportionally more expensive to service a microloan than a larger loan. Moreover, the poor infrastructure in developing countries leads to high costs. But this argument is not consistent with empirical evidence. In a July 2009 analysis of 22 MFIs in Mexico, Waterfield shows a very wide range of loan prices—from 38 percent to 90 percent—with similarly sized loans.12 Analysis of 48 MFIs in the Philippines and 31 MFIs in Ecuador yields similar results. As Waterfield’s analysis holds the loan size and environment constant, the price differential is likely due to local monopoly power, which leads to high profits. Costs measured by operating expenses as a percentage of loan portfolio also vary widely—ranging from 25 percent to 55 percent—for Philippine MFIs with similarly sized loan products. Once again, since this analysis controls for loan size and the environment, the cost differential is likely due to some MFIs

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having unreasonably high controllable costs. In Bangladesh in 2006, the state-backed wholesale funder of microfinance publicly voiced concerns about poor borrowers having to pay high interest rates because of inefficient MFI operations. In a competitive industry, such wide differentials in costs and prices would not persist, and firms with inefficient operations and high prices would be penalized. This is further evidence that microcredit is a monopolistic industry, and regulated interest rate caps are needed urgently.

Fernando argues that interest rate ceilings will reduce the availability of microcredit. A CGAP paper by Brigit Helms and Xavier Reille concurs that interest rate ceilings “often hurt rather than protect the most vulnerable by shrinking poor people's access to financial services.” The flaw in this argument is the assumption that microcredit is a competitive industry. Price controls in a competitive industry will lead to reducing supply; but that is not true in a monopolistic industry. Setting an appropriate interest rate ceiling will actually expand the availability of microcredit, given the monopolistic nature of the industry. This should not be difficult, since the gap between the competitive and monopoly price today is so big.

ABUSIVE LOAN RECOVERY

Microcredit is also coming under increasing criticism for its debt collection practices. Although there is no systematic evidence, there is anecdotal evidence that some MFIs use coercion to enforce loan repayment. In Kalihat, one of the first Bangladeshi villages to benefit from Grameen’s low-interest credit scheme, the villagers who have taken out a loan are unable to reimburse their credit and claim to be harassed by Grameen Bank representatives. Korshed Alom, a former debt collector, was put into early retirement for questioning Grameen’s methods. “Their technique is to scare borrowers and insult them,” he told France 24 in a June 4, 2008, report on microfinance. “We tell them to sell their clothes, that they have no other choice. I’m not proud of myself, but several times I had even been obliged to say, ‘Sell your children.’”

Some MFIs in Andhra Pradesh were charged with intimidating borrowers with forced loan recovery practices. According to a Jan. 8, 2008, Wall Street Journal article, one delinquent borrower was violently beaten by a thug working for a collection agency that was hired by ICICI Bank. The Delhi Consumer Commission fined ICICI for what the judge called “the grossest kind of deficiency in service and unfair trade practice.” In Mexico, clients of Azteca who slipped behind on repayment received frequent visits from motorcycle-riding collection agents, according to a Dec. 13, 2007, BusinessWeek article. Much microcredit relies on group liability. Sometimes the coercive practices are undertaken not by the MFI but by the group members.

Exploitation can occur even without an MFI using coercive loan recovery practices. All that is needed is for the borrower to believe coercion will be used. A survey of clients of two microfinance organizations in India finds that 53 percent of respondents believed “it is all right” for an MFI to confiscate assets such as cows, house, land, and machinery if the borrower is unable to repay the loan. This is particularly disturbing because the crux of microfinance is collateralization. The survey results do not imply that assets are in fact confiscated by the MFI in the event of default, but the perceived threat of confiscation (or any other threat) is in itself intimidating and abusive.

ALTERNATIVES TO REGULATION: TOO LITTLE, TOO LATE

The potential for consumer exploitation in the case of microcredit is a direct result of market failure. This failure is due to two underlying causes: first, too little competition; many MFIs exercise significant market power that results in very high interest rates. Second, the consumers of microcredit are ill informed, which allows MFIs to be non-transparent in loan terms and engage in abusive recovery practices. When the profit-maximizing behavior of firms in a free market results in negative consequences to public welfare, constraints need to be imposed. Constraints can be achieved through four approaches: corporate social responsibility, self-regulation by the industry, activism by civil society, and government regulation.

Many MFI proponents do acknowledge the problems of consumer exploitation but do not like the solution of regulation. They plead with microcredit organizations to act more ethically, or argue that the industry should regulate itself. These responses are at best narrowly optimistic and will not work.

Commercial organizations given opportunities for increasing profits usually act in their self-interest. In a Jan. 20, 2005, survey on corporate social responsibility (CSR), The Economist magazine concluded that for most public companies, “CSR is little more than a cosmetic treatment.” Appeals for self-restraint on the grounds of ethics and values have not been effective in the business world, and there is no reason to believe commercial microcredit organizations will be any different.

An appeal on ethical grounds is complicated by the fact that industry participants do not agree on a common set of values. A group of leaders in microfinance signed the Pocantico Declaration in April 2008 in an attempt to develop common ground and a set of principles. Unfortunately, the declaration is full of vague statements and platitudes, and no consensus on specific issues. In fact, it indicates explicit dissent when it states, “We also recognize that we hold diverse views about the appropriate levels and usage of profit.”

There has been much discussion about the microcredit industry regulating itself. Alex Counts, CEO of Grameen Foundation, proposes a third-party certification scheme in his summer 2008 Stanford Social Innovation Review article, “Reimagining Microfinance.” The major drawback is that there is no authority to ensure compliance. Since 1993, 33 microfinance organizations have joined the Microfinance Network and signed a Pro-Consumer Pledge that states “members will price their services at fair rates. Their rates will not provide excessive profits, but will be sufficient to ensure that the businesses can survive and grow to reach more people.” All that needs to be said is that Compartamos is one of the members of this network.

On a larger scale, the American experiment with deregulation of the financial services industry has been a failure, and the United States is now on a path toward greater government regulation. There is little reason to believe that the microcredit industry in developing countries will succeed in self-regulating while facing much less competition, less scrutiny, and more vulnerable consumers. In 2005, South Africa switched from relying on the Micro Finance Regulatory Council, which used a self-regulatory approach, to establishing the National Credit Regulator, which is a classic public sector regulator.
Another potential source of constraints is citizen activism. In developed countries, citizen activism has succeeded even when there are no governmental regulations. Witness the recent pressure on McDonald’s to introduce healthier menu options. But activism is inadequate in most developing countries, because so many citizens lack the resources, awareness, and traditions necessary for such empowerment. There are few activist movements exerting pressure on MFIs to reduce or prevent exploitation of microcredit consumers. One is the popular debtors’ rebellion in Nicaragua—the “No Pago” (I Won’t Pay) movement—that has spurred mass demonstrations protesting high interest rates and demanding a legal ceiling on them.

It is doubtful that CSR is an effective constraint on firm behavior even in developed countries, let alone in less developed countries. Institutional maturity and public support are needed for effective action by civil society and for self-regulation by industry. As countries develop economically, politically, and socially, these mechanisms for constraining markets will improve. But we should not tolerate exploitation of the poor today while we wait—probably a long time—for such changes to occur. For now, government regulation is the best way to protect microcredit clients.

THE PATH TO REGULATION

The best place to start the regulation of the microcredit industry is to require transparency on loan terms. The U.S. Truth in Lending Act of 1968 requires all financial firms to disclose the annual percentage rate (APR), using a standardized formula that takes into account the various loan terms and fees. The European Union and the United Kingdom have similar regulation, although they use a different formula. The key is to mandate a standard formula that facilitates comparisons across loan providers. Implementing transparency regulation for microcredit should be fairly easy, since such regulation does not require many government resources and is unlikely to be controversial.

Developed countries have laws regulating recovery of personal loans. In the United States, the Fair Debt Collection Practices Act of 1978 prohibits debt collectors from using abusive, unfair, or deceptive practices to collect personal debts. Collectors are even prohibited from repeatedly telephoning debtors. Enforcing such laws, if they existed in developing countries, might be difficult, especially in rural areas. But difficulty is not a good reason to avoid implementation. Governments should regulate microcredit loan recovery practices and attempt to enforce the regulation. In addition, governments and civil society organizations should better educate microcredit borrowers about their rights. This is clearly an uphill battle—all the more reason to get started soon.

Today, 40 developing countries impose ceilings on interest rates. Many developing countries liberalized interest rates and removed limits during the 1980s as part of financial sector reform. This was appropriate, since there was enough competition among financial service firms catering to middle-class and affluent people in developing countries. But the same is not true for microcredit targeted at the poor. As Yunus pointed out in 2007, “The existing regulations are designed with commercial banking in mind, but microfinance requires a dedicated regulator and a relevant set of rules.” In Bangladesh in 2004, when there were no laws limiting interest rates, the state-backed wholesale funder of microfinance capped the on-lending rate of all its clients at 24 percent annual effective rate. More recently in 2009, the Microcredit Regulatory Agency in Bangladesh announced that MFIs must limit the interest rate to 30 percent. A 2004 presidential decree in Bolivia also imposed interest rate ceilings on small loans. Each country’s government needs to determine the appropriate interest rate ceiling for microcredit, so that it is high enough to cover operating costs and reasonable profits and not so low as to stifle the development of the industry—nor so high as to be exploitative of the poor.

Although I believe governments should be the primary force in regulating microcredit, there still is a role for other organizations to constrain the behavior of MFIs. Industry self-regulation can be a useful supplement to legal regulation. International donor organizations, such as the World Bank and U.S. Agency for International Development, can put pressure on their MFI clients to reduce or prevent exploitation of the poor and to help governments draft appropriate regulations and transfer knowledge of best practices. Large commercial banks that are wholesale lenders to MFIs should exercise their social responsibility and press their MFI clients to behave responsibly. And civil society organizations can play a large role in shining the light on MFIs that behave inappropriately and in educating poor borrowers about their rights. But none of these approaches can be sufficiently effective without government regulation.