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CHAPTER 2

MICROFINANCE AND INTEREST RATES: A REVIEW

2.1 INTRODUCTION

It has been estimated that there are about 500 million economically active, poor people in the world operating small businesses (Women's World Bank, 1995). Most of them do not have access to adequate financial services (Ledgerwood, 1999). This could be attributed to the fact that most of these people do not have collateral to substitute for credit, or their only form of security is low income. Microfinance has evolved as an economic development approach intended to benefit the low-income population.

Growth in the scale of micro finance activities in most parts of the world is limited by a variety of existing laws, including those dealing with organisational forms, prudential standards, interest rate limits and secured finance (Meagher & Mwiinga, 1999). Most micro lending firms are able to operate due to selective non-application of such rules with tacit agreement of government, or they function efficiently while adhering to the existing laws. The overall political and economic environment of a country affects how micro finance is provided (Ledgerwood, 1999). A Government's economic and social policies, as well as the level of development of a countries' financial sector, influences micro finance organisations in the delivery of financial services to the poor.

Micro finance lending can be divided into two broad categories, consumption and productive lending. Consumption lending is what drives South Africa's micro lending industry (Grant, 2000). Consumption borrowing is defined as borrowing to provide cash flow for consumption purposes e.g. food or transport. The latter category, productive lending is defined as borrowing by informal traders and small businesses to provide capital and cash flow for trading purposes. While lending for consumption purposes is

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not the same as lending for enterprise development, the two are closely linked within the financial services sector. They both target clients from similar income levels, i.e. low-income individuals.

The next section will present the overview of existing literature, followed by the role of micro finance in economic development in South Africa; thereafter the experience in micro lending around the world will be explored, followed by experience from South Africa.

2.2 THE ROLE OF MICROFINANCE IN ECONOMIC DEVELOPMENT IN SOUTH AFRICA

The goal of microfinance institutions (MFI's) as development organisations is to service the financial needs of un-served or under-served markets as a means of meeting development objectives. These development objectives include one or more of the following (Ledgerwood, 1999):

- To reduce poverty
- To empower women or other disadvantaged population groups
- To help existing businesses grow or diversify their activities
- To encourage the development of new businesses.
- To create employment and income opportunities through the creation and expansion of microenterprises.
- To provide access to financial services to people excluded by the formal financial sector, thus effect deepening in the financial sector.

One year after the democratic election, the then President of South Africa, Nelson Mandela, appointed the Commission of Inquiry into the Provision of Rural Financial Services. This Commission (Strauss Commission) submitted its interim report in March 1996 and the final report in September of the same year. The report first looked at the

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demand for financial services in rural areas, described the financial services of the different financial institutions, and made extensive recommendations based on this. The recommended measures were primarily aimed at improving access to financial services in rural areas where it was found that there was a lack of supply.

The microfinance sector is also receiving increasing attention from the government and the Central Bank. A year after the submission of the Strauss Commission report in September 1996, a workshop on micro lending was held at the South African Reserve Bank and both the Deputy Minister of Trade and Industry and the Register of Banks took part. In his speech the Registrar of the Banks, acknowledged that there is an urgent need for social upliftment in South Africa, and that much hardship is caused by unemployment (Wiese, 1997). He further stated that as a country they should aim to enable the poor and the unemployed to empower themselves financially by promoting the development of small business.

Small businesses have a major role to play in the South African economy in terms of employment creation, income generation and output growth. One of the problems with far-reaching political and economic repercussions is high unemployment, particularly in the townships and rural areas. Small and micro businesses in the informal sector are frequently the only source of employment for the urban black majority of the population (Reinke, 1996) cited in DTI (2000). The Reconstruction and Development Programme (RDP, 1994) stated specifically that small businesses, especially those owned and operated by black entrepreneurs, must form an integral part of the national economy.

Small, medium and micro enterprises are the vehicle by which people in the lowest-income groups in society gain access to economic opportunities, at a time when the distribution of income and wealth in South Africa is amongst the most unequal in the world. In the current macroeconomic context, it is imperative that significant investment is made in SMMEs in order to create both short and long term capacity for labour absorption and output growth, as well as to improve income generation and

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redistribution. Small enterprises employ on average five people, therefore contributing to the job creation.

One of the key stumbling blocks preventing the dynamic growth of this sector is the lack of access to small, short-term loans. The commercial banking sector in South Africa ignores the micro enterprise sector and has failed to recognise that lending to this sector can be profitable (Mlambo-Ngcuka, 1997). The exclusion of many small and medium enterprises from access to, and use of, formal financial institutions was due to the perception of lending institutions that small-scale entrepreneurs had a general lack of adequate collateral, security, equity capital and business track record, against which to measure their credit-worthiness (AMEDP, 1996).

Micro lending institutions in South Africa arose and have tried to meet the financial service requirements of this sector of the economy. However, in order for these institutions to survive, the government must recognise that integral to ensuring increased access to credit, is a policy framework, which creates an enabling environment for the establishment and sustainable operation of micro lending institutions.

Micro lending is costly and even among efficient institutions, administrative cost range from 10% to 20% of average loan portfolio (CGAP, 1996). Therefore, if the aim is to create sustainable and efficient micro lending institutions, the government must recognise that the Usury Act could constrain delivery of financial services to micro enterprises and the majority of low-income population.

2.3 INTEREST RATE CEILINGS AND CREDIT RATIONING

Usury regulation is a topic with a long history of discussion, nevertheless the debate over the merits of usury regulation continues to the present day. There is little doubt that usury laws effectively lower the finance rate to many borrowers obtaining loans from moneylenders. The notion that high-risk borrowers are rationed out of the market for

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credit as a result of legally established ceilings on interest rates has been a prevailing conclusion of previous studies dealing with this subject, Goudzwaard (1968), Greer (1974), Benston (1977) and Peterson (1983). It is said that the lower the ceilings the greater the number of rationed potential borrowers (Villegas, 1982).

The formal economic model of the impact of usury ceilings was outlined by Blitz and Long (1965). In their study they demonstrated how usury ceilings could lead to credit rationing. The financial market literature also attempted to explain credit rationing by considering legal and social constraints, high screening costs and most convincingly, asymmetric information in credit markets. These are elaborated in detail in Jaffee and Modigliani (1969), Jaffee and Russell (1976), Azzi and Cox (1976), Stiglitz and Weiss (1981) and Bester (1987).

One of the principal conclusions of the National Commission on Consumer Finance in the USA, was that the imposition of interest rate ceilings on consumer loans results in a reduction in loan supply with otherwise creditworthy borrowers being rationed out of the market (Eisenbeis & Murphy, 1974). Therefore, it is particularly important that the credit availability and credit rationing impact of rate ceilings be thoroughly understood by the architect of the proposed legislation. Setting a relatively low price ceiling will result in some borrowers being rationed out of the formal market and they will then become prey to illegal lenders who charge exorbitant interest rates as these borrowers still need to satisfy their demand for financial services.

As Gonzalez-Vega (1977) points out that if restrictions are imposed on rates of interest, lenders may practice credit rationing, i.e., granting smaller loans than those demanded at the rate charged. From the point of view of the individual borrower, rationing implies an excess demand for credit at the rate of interest paid (Jaffee, 1971 and Eckaus, 1973) cited by (Gonzalez-Vega, 1977). Generally a lender restricts the size of a loan if the marginal cost of granting it is higher than the imposed rate of interest. Since the marginal cost is an increasing function of the size of any individual loan, the lender can reduce his marginal cost and equate it to the imposed rate by reducing the size of the loan. If this rate

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becomes sufficiently low, dropping below variable cost, rationing takes the form exclusion from the lender's portfolio.

The possibility that a borrower will be rationed depends on the relationship between the marginal cost and the demand functions faced by the lender and on the nature of the restrictions. The slower the marginal cost rises as the size of loan increases, a function of risk, and the faster the quantity of credit demanded increases as the rate of interest declines due to the behaviour of the value of the marginal product of the inputs, the less likely is rationing. Gonzalez-Vega (1977) further states that the low ceilings imposed on rates of interest for loans in low-income countries have led to the widespread rationing.

The effects of rate ceilings on credit allocation can also be presented with the aid of a diagram (table 2.1) below. According to the conventional theory of markets, conditions of perfect competition yield a market situation in which demand and supply schedules intersect at equilibrium, with no excess demand or supply (Greer, 1975). The rationing effect is often demonstrated in conventional supply-demand diagrams by a price ceiling, which falls below the intersection of competitive supply and demand functions (figure 2.1)

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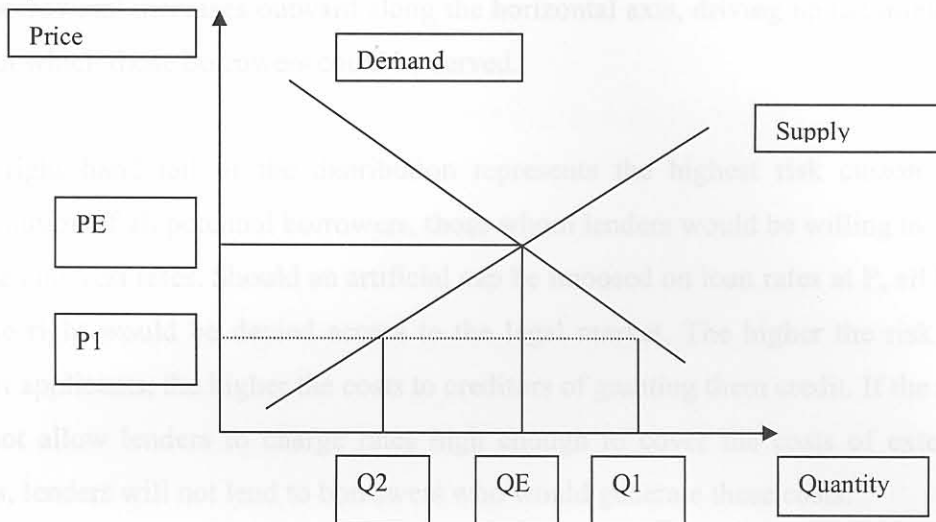
Figure 2.1: The effect of an interest rate ceiling on the supply of loans



Source: (Black et al, 1997)

The interaction of supply and demand determines the equilibrium interest rate at (PE, QE), but the interest rate ceiling sets the rate at P1. At P1 there is a shortage of loans supplied. Since interest rates are not allowed to rise above P1, there is no incentive to expand the quantity of loans offered, and thus the supply is rationed. Some suppliers may in fact leave the market altogether so that the supply curve shifts inwards and the shortage will become even more acute (Black et al, 1997).

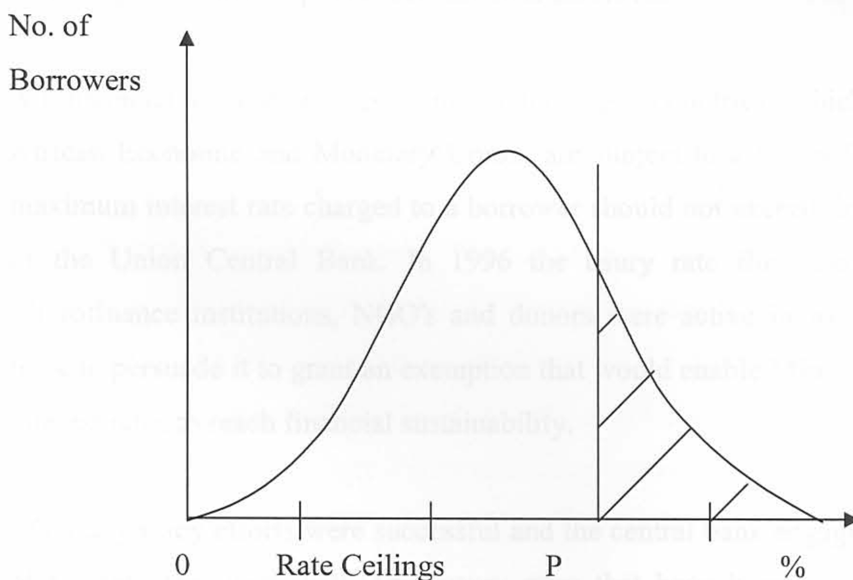
The rationale for interest rate ceilings is for consumer protection, but as these consumers need cash urgently they often resorts to informal moneylenders who charge interest rates far higher than P1 or even PE. Therefore the imposed price ceiling does not achieve its objective.

Staten and Johnson (1995) also showed the impact of rate ceilings on the availability of cash credit to high-risk borrowers as illustrated in figure 2.2 below. The borrowers are arrayed along the horizontal axis according to the minimum percentage finance charge at

which creditors will be willing to extend to them. A small number of low-risk borrowers comprise the left tail of the distribution of all borrowers. Repayment risk associated with the borrowers' increases outward along the horizontal axis, driving up the minimum loan rate at which those borrowers could be served.

The right hand tail of the distribution represents the highest risk customers in the distribution of all potential borrowers, those whom lenders would be willing to serve only at high interest rates. Should an artificial cap be imposed on loan rates at P, all borrowers to the right would be denied access to the legal market. The higher the risk posed by credit applicants, the higher the costs to creditors of granting them credit. If the regulators do not allow lenders to charge rates high enough to cover the costs of extending the loans, lenders will not lend to borrowers who would generate these costs.

Figure 2.2: Effect of rate ceiling on availability of cash credit to borrowers



Source: Staten and Johnson (1995)

A rate ceiling does not only ration high-risk borrowers out of the market, but also tends to ration out borrowers seeking small loans. In addition to the costs associated with credit risk, there are administrative costs in granting loans and managing subsequent collections. Since many of these costs are fixed and unrelated to the amount of loans

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generated, they are proportionately higher for smaller amounts of loans. If these costs are not covered by the permitted finance charge, credit will not be extended, even to low risk borrowers.

2.4 MICRO LENDING EXPERIENCE AROUND THE WORLD

Microfinance institutions have emerged around the world in response to the need for financial service provision in developing economics. While many individual organizations are growing, the legal and regulatory environment in which they operate has not caught up (Meagher & Mwiinga, 1999). Pushing governments to develop legal frameworks for microfinance may, in at least some countries, risk setting a process in motion the result of which could be the imposition of interest rate controls (Christen & Rosenberg, 1999). Interest rate controls can make sustainable MFI's impossible or at least discourage outreach to poorer customers if enforced.

All financial institutions operating in the eight countries, which make up the West African Economic and Monetary Union, are subject to a Usury law providing that the maximum interest rate charged to a borrower should not exceed double the discount rate of the Union Central Bank. In 1996 the usury rate fluctuated around 13 percent. Microfinance institutions, NGO's and donors were active in working with the central bank to persuade it to grant an exemption that would enable MFI's to charge high enough interest rates to reach financial sustainability.

Their advocacy efforts were successful and the central bank engaged itself in the process of revising the usury law. Two usury rates that have been proposed are one for the Commercial banks (18 percent) and one for microfinance institutions (27 percent). The flexibility of the central bank demonstrates an understanding of the important role that microfinance institutions are playing in West Africa (Ledgerwood, 1999).

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When modern microcredit emerged in Latin America, almost all of the countries had legal limits on interest rates. These limits were set far too low for sustainable microcredit delivery. Most of the microcredit pioneers practised regulatory avoidance by mounting their operations in NGO's. If the laws had been enforced literally in some of these countries the usury limits and even a requirement of financial licensing would have applied to all microcredit operations. However, the microcredit NGO's were left alone, the authorities being unaware of, or unconcerned with their existence (Christen & Rosenberg, 1999), or allowing them to operate outside the law due to their development role

Innovation flourished, and masses of successful MFI's, which were strong enough to justify a formal financial license, emerged. In the meantime, government policy and public attitudes about interest rates had changed, because of the demonstrated demand for these high interest rate loans. By the time strong MFI's were ready for licensing; interest rate repression was no longer an issue in most of these countries. Christen and Rosenberg (1999) point out that all this happened because the governments involved, were not prematurely forced to take a public position on microcredit interest rates.

The US experience of the past 25 years (Staten & Johnson, 1995) has shown that competition in the credit market has dramatically expanded the range of loan products and features available to consumers, facilitated by the relaxation or removal of rate ceilings in most states. They found that the removal of rate ceilings brought more, and new, competitors to the market with resultant positive impact on the price and availability of consumer credit.

2.5 MICRO LENDING IN SOUTH AFRICA

2.5.1 Usury Act (No.73 of 1968)

Banking legislation in South Africa is promulgated in the form of acts (Staschen, 1999). These can be supplemented and specified by Government notices published in the Government Gazette. The important relevant laws are the Banks Act and the Usury Act.

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For the purpose of this study we will concentrate on the latter, which is of importance to the microfinance industry. The Usury Act imposes interest rate ceilings on loan finance. The main objective of this study is to investigate the impact of the Usury Act and the imposition of the interest rate ceilings on microlending loans.

The Usury Act, (No. 73 of 1968) was approved on the 20th June 1968 and commenced on the 1st April 1969 (CISA, 1998). The purpose of the Act was the limitation and disclosure of finance charges on money lending transactions, credit transactions and leasing transactions. The Usury Act (No.73 0f 1968) as amended, regulates and controls the price of money and the nature of credit relationships. The Act is further supposed to protect the borrower from exploitation and usurious rates and therefore serves a major goal of regulation.

On the 30th June 1994 the Minister of Finance announced in the Government Gazette (Notice 15836) that he was considering repealing the Exemption (Aveyard, 1999). The Minister's actions were as the result of the outcry from both public and consumer groups. It was believed that the micro lending industry was getting out of control and consumers were being severely exploited

In 1997 the DTI began a process of modifying the Usury Act largely because it was dissatisfied with the level and consistency of consumer protection supposedly afforded by the Act (DTI, 2000). The Minister invited written representations from the public and various stakeholders regarding the intention to repeal the Exemption. In response to the process that began in 1997, on the 1st June 1999, the DTI issued a Notice in terms of section 15A of the Usury Act 1968 (No.73 of 1968) to exempt the category of money lending transactions. The new exemption stipulated the following (Government Gazette, 1999):

- A regulatory institution must be established to regulate the industry, known as the MicroFinance Regulatory Council (MFRC).
- A micro lender must be registered with the regulatory body and must comply with the rules set out by the body.

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- The loans shall not exceed R10 000 with loan term not exceeding 36 months.
- The interest rate shall not exceed ten times the prime rate

2.5.2 Background of the Micro Lending Industry

There still exists a high level of un-informedness regarding the micro lending industry. Therefore, it is considered appropriate to provide a general background to the industry. Operators in the industry make credit available to millions of individuals who are unable to obtain loans from the formal banking sector.

With the new South Africa of the 1990s people had high hopes in terms of economic development. It was argued that one of the major hindrances to the development of this disadvantaged sector was the lack of access to finance. Due to the structural changes taking place in the South African economy, a large number of unskilled workers find it impossible to be employed in an economy, which is more focused on the services sector by the day. The government realised that the only way to provide employment for the unemployed was through the creation of small and micro businesses. But this couldn't be realised without access to support services and also finance.

Access to finance for the majority of the population came through the evolution of the microlending industry. The industry flourished as a result of its exemption from the Usury Act. The amendments of the Usury Act together with high margins, low barriers to entry, and the vast demand for finance, which has not been met by commercial banks, fuelled this growth. The industry has exploded over the last few years attracting an estimated 30 500 micro lenders from both formal and informal markets (Thordsen & Nathan, 1999).

Du Plessis (1997) describes the formal and informal micro lenders as follows; the formal micro lenders are those operating from fixed premises, in addition they have the normal and most modern electronic infrastructure, and lastly they openly advertise their services in the areas they operate. The informal micro lenders are those who do not operate from

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fixed premises, do not have listed phone or fax numbers and they prefer not be identified by any other than their clients. They are operated underground i.e. not within jurisdiction of laws, taxes and other regulations.

Between 1992 and 1999 the industry was constantly being accused of unscrupulous practices, charging exorbitant interest rates, lenders not registering for tax and using illegal collection methods (some lenders accused of keeping borrowers bank cards and personal identification numbers (PIN)). In 1997, the DTI began a process of modifying the Usury Act largely because it was dissatisfied with the level and consistency of consumer protection supposedly afforded by the Act. Submissions from various stakeholders within the industry were brought forward, and this led to the government issuing a new exemption notice in 1999.

The Association of Micro Lenders (MLA) challenged the appointment of the MFRC as regulatory institution, the interest rate calculation and the Exemption Notice in the High Court. In his judgement on the 11th November 1999 the presiding judge, Judge Mynhardt, held that the Minister did not act outside his powers in terms of Section 15A of the Usury Act 1968 in issuing the Exemption Notice and in appointing the MFRC as the regulatory body. The judgement ruled that the keeping of bankcards and PIN numbers, as security was illegal. However, it also ruled that the definition of the Usury rate at 10 times prime needed to be examined as the government did not study the issue of interest rate ceilings and their impact on the industry before deciding on this interest rate ceiling.

The DTI was therefore faced with the task of determining whether there is a reasonable rate of interest which can be charged by lenders and still earn an adequate living from the service provided. Based on this, the DTI initiated a study on the costs and interest rates of small loan sector (DTI, 2000). The purpose of the study was to help the DTI understand the overall structure of costs of various lending institutions, to determine their actual interest rates and to investigate which criteria should be applied in decisions on interest rate controls.

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The study came up of with number of recommendations on the interest rate ceilings. Its first reaction was to not recommend setting any interest rate ceiling at all, because it realised that setting interest rate ceilings will restrict the flow of credit into the system by forcing marginal lenders to close or go underground. But the study further proposed that if the DTI insists on setting interest rate, they should not be based on the cost of money, but based on administrative costs of making the loans. The study recommended the DTI to set the interest rate ceiling as high as possible and should set it as fixed rate. Placing a fixed rate of interest will allow investors to do their calculations and determine where they wish to invest their money.

The study further recommended that if rate ceilings are being set based on the administrative costs, the DTI should address the short-term cash lenders separately from the term lenders, as they have extremely different cost structures due to their method of operation and risk profile of their clients. It proposed that the ceiling for the short-term lenders be placed at 30 percent (effective interest rate) initially, and the ceiling for the term lenders at 10 percent (effective interest rate), with targets for gradual reduction over the period of one to two years.

2.6 THE ARGUMENT FOR FULL COST-RECOVERY INTEREST RATES

Many industry observers believe that micro lenders' interest rates are excessively high. A perspective however needs to be taken. As micro lenders are not deposit taking institutions they are in effect retailing their own money, which is therefore a commodity and their stock-in-trade (Jonck, 1997). Micro lenders in South Africa accepts and acknowledge that their interest rates are high as compared to the formal banking sector, but argue that higher risks that they carry because their loans are unsecured should not be ignored (Jonck, 1997).

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Most people, especially those who are at the forefront in accusing the industry seem not to understand the risks involved in operating a micro lending business. It should be understood that the cost of administering a small loan is the same if not higher than that for a bigger loan, this is the reason why micro lending is unattractive to the formal banking sector. "Many of those appearing before the Committee argued that the banks were unfairly treating and indeed abandoning lower income customers. This was also seen as the context within which the small loans industry had mushroomed. The latter was providing much needed credit to people who would otherwise not have access to credit or banking services" (Report of the Portfolio Committee on Trade and Industry, 1999).

Interest rates charged by micro lenders are higher as compared to commercial bank rates. These could be attributed to a number of factors. Firstly the micro lenders have higher incidence of bad debts because of the target markets' higher risk profile. In low-income market in particular bad debt feeds upon itself in that once borrowers see that other clients are not paying their loans, they quickly adopt the others' behaviour (AMEDP, 1996). Secondly, the average loan is low while the costs of granting and administering a loan are high and fixed.

The micro lending institutions on the other hand, do not require conventional collateral to lend, they generally practice character-based lending. They rely more on a client's willingness to repay when assessing loan applications, and it is rare to find an application taking more than a day to be processed. One of the key factors influencing the lack of supply of credit to small enterprises and low-income earners is the non-recoverability of costs (AMEDP, 1996). The interest charge on credit is the main source of income for micro lenders. When the government implements interest rate ceilings on loans provided by micro lenders without first determining the cost structure of these institutions, the results could be detrimental.

The majority of the people, especially organisation such as the consumer groups, believe that an interest rate ceiling would be simple and straightforward and would protect

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consumers (Jonck, 1997). The industry argues (Jonck, 1997) that if lenders were not allowed to charge full-cost recovery interest rates, the majority would close down businesses as a result of non-recoverability of costs. Therefore consumers would be left as prey to the unscrupulous loan sharks that form part of the informal sector of the industry. The most important argument in the field of microfinance is that the poor demand access to credit, not cheap credit (Morduch, 1998).

Although full-cost recovery interest rates may be an economic requirement for the sustainability of micro lenders, some people argue that the poor still deserve to be protected by an interest rate ceiling. It is argued that poor people cannot afford to pay exorbitant rates of 40% or 50% or even more (AMEDP, 1996). Many studies around the world have shown that effective rates of full-cost recovery credit are often lower than those charged by informal moneylenders.

2.7 SUMMARY

Small businesses have a major role to play in the economy of South Africa in terms of employment creation and income generation. But one of the key stumbling blocks preventing the dynamic and growth of this sector is the lack of access to small, short-term loans. Micro lending institutions rose to fill this gap. Due to public outcry concerning activities of some of the operators within the industry came the Usury Act which act as a constrain to the delivery of financial services to micro-enterprises and the majority of low-income population.

The Usury Act (No.73 of 1968) as amended regulates and controls the price of money and the nature of credit. The sole purpose of the Act was to protect the borrowers from perceived exploitation. In 1992 the government Gazette Notice 14498 was issued, which exempted loans of under R6000 from the Usury Act. Due to public and consumer outcry, during 1999 the government issued the Gazette Notice 20145 repealing the 1992 exemption.

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The Association of Micro Lenders challenged some of the clauses in the 1999 Usury Act amendments in the High Court. In his judgement, Judge Mynhardt held that the Minister did not act outside his powers in terms of Section 15A of the Usury Act (No.73 of 1968) in appointing the MFRC as the regulatory body. However, he also ruled that the definition of the Usury at ten times the prime rate needed to be examined, as the government did not study the issue of interest rate ceilings and their impact on the industry.