

CHAPTER 6

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

6.1 INTRODUCTION

The main objective of this study was to analyse the impact of interest rate ceilings on the micro lending market. This was achieved by applying simple and multiple regression techniques to data consisting of monthly observations of a micro lending company with branches. The theoretical analysis from other literature was also applied to this study to show the effects of rate ceilings. This chapter summarises and links the conclusions of the previous chapters to show the importance of microfinance institutions, the evolution and size of the micro lending industry, and lastly the effects of rate ceilings.

6.2 SUMMARY

The goal of MFI's is to service the financial needs of unserved or underserved markets as a means of meeting development objectives. They do it for profit motives, and in the process also contribute to the development of the financial sector. In South Africa (Daniels, 2001; MFRC, 2001) it was shown that a significant improvement in access to financial services occurred over the last decade. Coetzee and Grant (2001) also showed that this is not necessarily only in the consumer credit provision, as a general leakage does occur between consumer and enterprise credit. This contributes to meeting some development objectives as outlined by Ledgerwood (1999). These development objectives include one or more of the following, to reduce poverty, to empower women or other disadvantaged population groups, to help existing businesses grow or diversify their activities, and/or to encourage the development of new businesses.

Small businesses have a major role to play in the South African economy in terms of employment creation, income generation and output growth. The problem of high unemployment, particularly in the townships and rural areas is one with far-reaching political and economic repercussions. Small and micro businesses in the informal sector are frequently the only source of employment for the urban black majority of the population.

One of the key factors that is seen to be preventing the dynamic growth of this sector is the lack of access to small, short-term loans and in general to financial services. The commercial banking sector in South Africa does not serve the micro enterprise sector, and has failed to recognise that lending to this sector can be profitable. Micro lending institutions have risen and tried to close this gap.

Operators in the micro lending industry make credit available to millions of individuals who are unable to obtain loans from the formal banking sector. Micro lending is therefore described as a provision of small loans to individuals who do not have access to formal banking because their only form of security is low-income. Access to finance for the majority of the population came through the evolution of the micro lending industry. The industry flourished due to an exemption from the Usury Act. The amendments of the Usury Act together with high margins, low barriers to entry and vast demand for finance which has not been met by commercial banks, fuelled this growth.

The industry has shown explosive growth over the last few years attracting an estimated 30 500 micro lenders from the formal and informal markets (Thordsen & Nathan, 1999). The formal micro lenders are those operating from fixed premises, in addition they have the normal and modern electronic infrastructure, and lastly they openly advertise their services in the areas in which they operate. The informal micro lenders are those which do not operate from fixed premises, do not have listed phone or fax numbers, and prefer not to be identified by any other than their clients. They operate underground i.e. not within jurisdiction of laws, taxes and other regulations.

The micro lending industry is geographically distributed throughout South Africa. The industry is divided into three distinct categories of micro lenders, namely the formal, semi-formal and informal sectors. 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. Charging a rate of interest on credit is the main source of income for micro lenders. This is the only way by which micro lenders can recover their costs. If the lenders were not allowed to charge full-cost recovery interest rates, the majority would have no option but to close their businesses, or go underground.

The consumers use loans for a variety of reasons. Loans may be used for either production or consumption purposes. Consumers normally borrow money for the following: transportation, businesses, buying food and education. The formal banks due to various reasons do not offer these types of small loans. But companies and individuals, which are in the position to supply these kinds of loans, are being constrained by government laws, mainly the Usury Act.

There have been many theoretical and empirical studies concerned with the economics of usury laws. Many of these studies tried to highlight the impact of rate ceilings, either theoretically or empirically. Most of the studies concluded that rate ceilings have a negative impact on both the consumer and the lender. Blitz and Long (1965) provided the basis for several studies on the impact of rate ceilings. Goudzwaard (1968) applied empirical analysis to this topic by using simple regression analysis to financial data to demonstrate the credit reallocation impact of rate ceilings.

This study followed a similar approach to Goudzwaard (1968) and developed simple and multiple regression functions that were applied to the data from a micro lender. The data consisted of monthly observations of operational statistics of a micro lender obtained from the DTI (2000) study, which determined the cost structure and interest rates of small loan sector. The data employed is based on observations from March 1999 to March 2000.

For the purpose of this study, six equations were formulated. The first equation tested the relationship between the risk level and interest rate ceilings. In the second equation, another variable, average loan was added to test whether a positive significant correlation between interest rate level and risk would still hold even if the effects of an additional variable have been taken into account. Equations 3, 4, 5, and 6 were formulated to illustrate the impact of rate ceilings on the market structure and size of a micro lender with various branches. The market structure characteristics, which were analysed, were the number of branches and the average number of loans per branch. The number of branches was used as a measure of the size of the micro lending company, and the number of loans extended per branch was used as measure of outreach.

Regression result in the first equation showed that interest rate has a significant positive impact on risk. The second equation showed that this significant positive correlation between interest rate and risk holds even after the effects of average loan on risk has been taken into account. The third equation showed that there is a significant positive correlation between the interest rate charged and the number of branches. The positive correlation between the interest rate charged and the number of branches implies that as lenders are allowed to charge interest rates high enough to cover their costs the number of branches increases thereby allowing borrowers to have more options to a variety of lenders.

The fourth equation demonstrated that this positive correlation between interest rate and number of branches holds even after another variable (average number of loans per branch) has been taken into account. The fifth equation also showed that there is a significant positive correlation between interest rate and the number of loans per branches. It is probable that the level of rate charged would affect the number of loans made. Where the rate is low, to the point that lenders could not recover their costs, lenders would reduce the number of loans, hence supply was rationed. Therefore, the consumers whom the government is trying to protect will be left without any alternative to finance and will resort to “loan sharks” who are not monitored and normally charge unscrupulous interest rates.

6.3 CONCLUSIONS

The main objective of this study was to examine the impact of interest rate ceilings on the micro lending market. Both theoretical and empirical analyses were applied to show the effects of the usury law.

It was shown in theory, that interest rate ceilings can result negative effects for consumers. In the first instance, the rationing effect of a price ceiling was demonstrated in a conventional supply-demand diagram. The interaction of supply and demand determines the equilibrium interest rate, but the interest rate ceiling sets the rate below the equilibrium point. At that point there is a shortage of loans supplied. Since interest rates are not allowed to rise above the ceiling point, 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 could become even more acute. The study also indicated the effect on the profitability of a microlender if a ceiling is imposed.

Through literature the study also showed the impact of rate ceilings on the availability of cash credit to high-risk borrowers. 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 (chapter 2).

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 these costs, lenders will not lend to borrowers who would generate these costs.

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 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.

The study analysed the impact of interest rate regulation empirically by applying simple and multiple regression techniques to the data obtained from a micro lending company. The main finding of the analysis showed that the interest rate has a significant positive impact on risk. It also showed that the level of rate charged would affect the number of branches, hence on the size of the industry. Rate ceilings tend to prevent new entries into the market, therefore preventing competition and leading to inefficiencies.

According to economic theory, a competitive market is sufficient to prevent lenders from exercising power over pricing or earning more than a normal return. Therefore instead of regulating interest rates a more effective approach to ensure that the rates charged by micro lenders are appropriate is to encourage competition, as this will spur innovation aimed at reducing the risks and costs associated with micro lending. Other findings of the study showed that there is a significant positive correlation between the interest rate and the number of loans per branch. This implies that where the rate is low, lenders would reduce the number of loans, hence supply is rationed.

In fact, interest rate ceilings may well have the opposite effect than intended by government. Instead of being protected against too “high” rates the consumers may have less access to loan finance. This can also lead to rationing by the lenders, thus targeting

the more efficient borrowers with large loans. Once again the poor will be those that suffer the most. An additional effect may be that the poor turn to the “underground” or “informal” lenders who do not obey the interest rate ceilings.

6.4 POLICY IMPLICATIONS

The preceding theoretical and empirical analysis showed that interest rate ceilings have a negative impact on the micro lending market. Many commentators argue that marginal risk borrowers are unaware of high rates, therefore should be protected with a rate ceiling, but Juster and Shay (1968) cited by (Villages, 1982) point out that even with full rate information many poorer risk borrowers would still demand loans at the same rate. This substantiates the belief that, to many borrowers the size of monthly payments is more important than the rate charged.

The fact that borrowers need some form of protection from other practices by micro lenders cannot be ignored, but whether they should be "protected" from paying an economically just price is debatable. It must be realised that this study does not suggest what the optimum maximum rate should be, or whether there should restrictive ceilings at all, but it merely demonstrates what the effect of interest rate ceilings on loan finance could be. The study demonstrated that any rate ceilings would likely effect consumer credit allocation, and that interest rate ceilings have important economic and credit rationing effects on the poor.

When government intervenes between consumers who willing to borrow and lenders who willing to lend, both parties will inevitably seek ways around the impediments placed in their way by the legislation. This is not necessarily either cynical or illegal; it is simply the way of the world. Evasive tactics invariably create additional costs. These costs, which are not productive in any way, will be passed on to customers (not even necessarily those who are borrowing) and to society as a whole. Jonck (1997) highlight the following as the sorts of evasive tactics that can be taken:

REFERENCES

- Lenders going “underground”
- Borrowers resorting to illegitimate lenders, usually extreme loan sharks
- Borrowers buying marketable goods, such as televisions on credit and selling them for cash
- Would be borrowers resorting to criminal activity as a last resort.

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