

Policy Framing Note 4: Interest Rate Policy

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This Framing Note is the fourth in a policy series by the Financial Access Initiative exploring various dilemmas which policymakers face across several topics of great importance to financial inclusion.¹ This paper describes the contours of the interest rate policy dilemma, updating previous sources with new theory about consumer behavior and new evidence from the demand side about how clients respond to interest rates; and from the supply side as to what drives the setting of rates. The focus here is not on interest rate policy in general, which would include its use in monetary policy, but rather the interest rate control regime applied especially to small or micro loans.

Summary

During the past three decades, interest rate regimes have been liberalized in a number of countries to legitimize and encourage small scale lending. However, the charging of high interest rates on small loans remains highly sensitive and often politically controversial. New evidence suggests that interest rates do matter to borrowers and, in addition to the well known imperfections of adverse selection and moral hazard in credit markets, new behavioral theory shows how borrowers don't always make the best choices. The empirical evidence on the welfare impact of small loans is limited and mixed to date.

The policy implications of these findings for the interest rate control regime are not simple to deduce: here, as in other areas of finance policy, policymakers and regulators face a dilemma which involves tradeoffs between greater access to financial services and the risk of abuse of consumers. While the theoretical arguments for interest rate liberalization remain strong, changes in the interest rate regime alone can have limited or even perverse influences on desired outcomes. This is because an

1. Other Framing Notes in the series will consider policies towards consumer protection, competition and prudential regulation. Clearly, these topics are closely linked, at least in perception if not always in reality. For example, capping interest rates had traditionally been seen as a means of consumer protection; and while competition in credit markets can bring many benefits, it can also result in abuse of borrowers leading to calls for protection.

interest rate control regime is in fact multi-faceted, involving many dimensions beyond simply whether or not to cap interest rates. Considerations include:

- On which size or type of loans do controls apply?
- What kind of control applies?
- Who sets limits and at what level?

Hard evidence of the effect of interest rate regimes to date is limited although it seems that changes in regime can have a strong incentive effect on private suppliers. The interest rate control regime is in fact only one tool in the financial regulators' toolbox, and it may be a "blunt" one with perverse consequences, especially if used in isolation. Other tools such as disclosure requirements, competition policy or effective consumer protection may be more suitable ways to manage the dilemma, depending on the nature of the problem in credit markets.

Introduction

The "microfinance revolution" has been built on two pillars. First, poor people are in general willing and able to pay high interest rates for small loans; and in consequence, second, it is not only legitimate to allow high rates on microloans, but also necessary for the sustainability of lending institutions which focus on the poor.

Partly in response to advocacy by the microfinance movement, legislators and regulators in a number of countries have liberalized their interest rate regimes over the past two decades. This has reversed a trend started many centuries ago of capping rates or even banning interest altogether, often for religious reasons. However, the level of interest rates on small loans remains a highly sensitive and inflammatory topic in many places. For example, the charging of exorbitant interest rates was one of the allegations which resulted in the closure of fifty branches of two microfinance institutions by district authorities in the Indian state of Andhra Pradesh in March 2006.² Indeed, the systemic credit crisis in the United States which started in 2007 and followed the liberalization of credit rates and lending practices starting more than thirty years ago, has again raised the question of how policymakers and regulators should regulate credit markets. In this area, they face another manifestation of the now familiar "regulators' dilemma" introduced in previous Framing Notes.

The regulators' general dilemma remains how to promote greater access to credit without causing consumer abuse and overindebtedness, or even worse from a prudential regulator's standpoint, a crisis in the financial system. The dilemma is sharpened in this case by the political sensitivity

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2. HS Shylendra, Economic and Political Weekly, May 20, 2006, p.1959-1963.

of the interest rate issue. Even regulators who are persuaded by the case to allow sustainable rates on small loans may have limited freedom to make desired changes: certain options, such as the full liberalization of interest rates, are simply not politically feasible, meaning that regulators are forced to consider the trade-offs associated with “second-best options.

We consider the rationales behind and nature of recent changes in the interest rate policy regime in four countries: one (Colombia) liberalized rates specifically on microcredit in 2006, whereas the other three, contrary to the previous trend and as a possible early indicator of a new trend, imposed or re-imposed rates controls but in different ways and for different reasons: South Africa (2005/7), Japan (2006) and the U.S. (2007). Most of these changes are too recent to judge their overall effect on access to credit and on consumers. No controlled experimentation has been done with interest policy regimes (as opposed to rates themselves) which would allow for definite conclusions about their impact; however, the different interest rate regimes across the fifty U.S. states provide some identification of the effect.

This Framing Note then considers the other tools in the regulator’s toolbox for navigating this dilemma, of which interest rate control regime is merely one. Depending on how the problem is understood, there may be other better ways of addressing credit market problems, including concerns about interest rates.

Interest rates and low income markets— theory and empirical evidence

MODERN THEORY OF INTEREST RATES

The theory of efficient financial markets makes a damning case against any cap or limit on market-determined interest rates. Shaw (1973), Mackinnon (1973) Goldsmith (1969) and more recently Levine (1997) describe financial systems in which interest rate caps create financial repression. The availability of loan finance is constrained, pushing borrowers into the informal market, where lenders can extract monopoly rents by charging high interest rates. Overall, conventional models of financial systems show that interest rate caps distort risk and return, and reduce overall economic growth rates. More specifically, interest rate caps constrain private lending to borrowers who are perceived to be higher risk such as small businesses and the poor. As a result, these market segments are under- or un-served by formal private credit; they may rely instead on heavily-subsidized state owned financial institutions. In repressed financial systems, financial services are usually low quality, with their scale often fiscally constrained since government must fund

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subsidized credit schemes to targeted groups. Much of the subsidy may end up with non-poor households and elites (Mackinnon 1973). Adams et al (1984) further suggest that interest rates that are too low can undermine the ability of microfinance to be sustainable since microfinance institutions are unable to cover the costs of their lending.

However, modern economic theory has come to recognize that unregulated credit markets are often far from efficient. This inefficiency stems from asymmetric information between borrowers and lenders which means that lenders cannot differentiate clearly the riskiness of borrowers at a given interest rate. Stiglitz and Weiss (1981) showed how this key informational feature of the credit market can lead lenders to ration credit, even at high interest rates. In consequence, even if policymakers liberalize the interest rate regime, this change may not in itself prevent credit rationing of some market segments.

The absence of complete information about borrowers' prospects or intentions leads to two specific problems which have been well identified in the economics literature:

- *Adverse selection*: high rates may simply attract higher risk borrowers ex ante such that the net return to a lender may still be negative; this could cause lenders to avoid lending at all in those markets which they perceive to be higher risk.
- *Moral hazard*: borrowers willing to pay higher interest rates may also be more incentivized to make more risky investments, leading to a higher rate of default on their loans ex post. Hence, the higher rate may in fact have a perverse effect which reduces returns to the lender.

Distinguishing between these two situations is not easy to do in practice, but the distinction is important since each carries different policy consequences: in a market with adverse selection problems, policy tools like subsidies or loan guarantees to lenders, promoting information coordination and enhanced screening tools may be necessary; while addressing moral hazard should lead to legal reforms in liability and garnishment in order to punish default and encourage lenders to use dynamic contracting schemes (such as repeat loans with increasing amounts, a feature of microcredit).

Recent advances in behavioral economics have delved even further into the reactions of borrowers to interest rates. Some policy stances are premised on the implied view that poor people are insensitive to high interest rates, based on the observation that individuals often borrow repeatedly at high rates (Rosenberg, 2002). One possible explanation is that the poor borrow to finance very high return investments, that is, they are rationally investing in micro-businesses with super-returns.

Although there is some evidence of high returns from microenterprise,³ there remain two problems with this line of thinking. The first is that the poor tend to stay poor; in other words, the benefits of apparently good investing do not translate into noticeable wealth accumulation, and this is true even at lower and subsidized rates of interest which should boost net returns to borrowing. The second problem is that many loans, even those ostensibly for business purposes, are used for consumption.

Banerjee and Mullainathan (2008) have proposed that the demand for credit, even at high rates, may be a reflection of innate impatience of the borrower that in itself creates a poverty trap. They suggest that this “temptation tax” is higher at the lower end of the income scale. At a low enough wealth level, the poor can never save enough so they simply dis-save. In other words, their poverty creates a bias towards consumption in the present, which in turn perpetuates their poverty. Hence, the impatience shown by the poor in borrowing at high rates is as much a result of their poverty as a cause. If so, higher interest rates help to perpetuate a negative cycle of poverty. However, even if proven true, this theoretical insight does not imply that interest rate controls, alone or in part, are necessarily the correct policy answer: rather, it shows how mounting evidence of behavioral biases such as these requires that policy should be more careful in accepting arguments that interest rates do not matter.

EMPIRICAL EVIDENCE ON THE SUPPLY SIDE

Empirical evidence on the supply side focuses on the questions of the extent to which lenders at the lower end of the market face problems of asymmetric information and whether they need to charge such high interest rates in order to be profitable. These issues are addressed in turn.

How severe are the asymmetry problems that suppliers face in practice?

The tricky nature of identifying these problems and collecting sufficient data has resulted in few comprehensive studies of this issue; but two are worth highlighting here. One considers an informal (illegal) money lending market in a particular region of Pakistan and the other the client base of a large formal consumer lender in South Africa.

Aleem (1990) studied the services, costs and charges of 14 informal market moneylenders and clients in Pakistan. His core question was whether the high implicit interest rates charged reflected the actual cost of operating in that market. The results showed that interest rates were close to average costs but higher than marginal costs, that entry into the market was free and that lenders differentiated their products. All of these observations are consistent with the view that the informal credit market is characterized by monopolistic competition, where interest rates rise above marginal costs to cover average costs. Informational asymmetries

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3. E.g. Suresh de Mel, David MacKenzie and Chris Woodruff finds high returns to capital among Sri Lankan microenterprises in “Returns to capital in microenterprises: Evidence from a field experiment.” *Quarterly Journal of Economics* 123(4): 1329–1372.

resulted in product differentiation, both because lenders could easily screen borrowers and because borrowers were not fully aware of the differentiated loan terms available from lenders. The market structure, comprised of many small, high average cost lenders without any information sharing about borrowers, made it hard for lenders to compete for borrowers or also for borrowers to switch lenders. All of these conditions resulted in the high rates observed. Clearly, it is difficult for policymakers to intervene directly in informal credit markets. However, Aleem also found that a significant source of moneylenders' funding was formal financial institutions, and he suggests that allowing formal interest rates to rise would discourage entry into the informal credit market and decrease the number of lenders in the market, thereby improving efficiency.

In research on a large consumer lender operating in the formal credit market in South Africa in 2002/3, Karlan and Zinman (2008c) used an experimental design to distinguish asymmetric information problems among borrowers. In their experiment, the lender mailed out offers to borrowers with the same observable risk. Adverse selection was identified by estimating whether loan repayment was worse for those who responded to a high interest rate offer compared with those who responded to a low interest rate offer. Moral hazard was identified by comparing the repayment behavior of those who were given a dynamic incentive, i.e., who were offered an incentive of lower interest rates for future loans based on the repayment of the current loan. They found strong evidence of significant moral hazard, which explained 7%–16% of default in the sample, but weaker evidence of adverse selection.

Does the nature of supplying credit to low income markets justify charging high rates?

It is not easy to get sufficient accurate cost information to analyze the cost drivers of lenders which focus on low income markets. Most of the recent evidence comes from the payday lending sector in the U.S., which lends to customers for short periods in advance of their regular paychecks. The research follows two main lines of enquiry.

The first is about whether payday lenders in fact make extraordinary profits. On the one hand, a presentation by a payday lender representative body (CFSA) to FDIC in September 2004 asserted that payday lenders could not break even with fees below approximately \$15 per hundred dollars borrowed; but conversely research by Stephens, Inc. (2004) asserts that payday lenders earn an extraordinarily high average annual pretax rate of return of 170% on initial investment.

The second line of enquiry is whether payday lending profits are made by encouraging chronic borrowing in vulnerable segments of the population. Reports from the Community Reinvestment Association of North Carolina

(Skillern 2002) assert that payday lenders make their money from chronic borrowers caught in a debt trap. Two researchers from the University of North Carolina (Stegman and Faris (2003)) agree. They analyze survey data collected by the North Carolina Department of Health and Human Services and conclude that the incidence of payday borrowing is higher among individuals who have recently moved onto the welfare system and with impaired credit histories. Also, using data from the Office of the Commissioner of Banks in North Carolina, they suggest that the industry is enhanced by turning occasional users into chronic borrowers.

But Flannery and Samolyk (2005) disagree on both counts. They criticize the Stegman and Faris (2003) study for not taking loan volume into account at the store level. The result, they argue, is a distorted picture: not that high frequency borrowers are more profitable than other clients per se, but that they are, by definition, a heavy proportion of the loan activity and therefore add more to store profits than other groups. In their own research, they used store-level data from two large payday lenders and examine how profitability relates to borrowing patterns of payday advance customers, default losses and store characteristics. They found that fixed operating costs and loan loss rates do justify a large part of the high APRs charged on payday advance loans. Volume is therefore the key to profitability. Their data does not support claims that loan renewals from frequent borrowers drive the profits of payday lenders. Also, controlling for loan volume, they find that economic and demographic conditions in the neighborhoods where payday lenders stores are located do not have a significant effect on their profitability.

EMPIRICAL EVIDENCE FROM THE DEMAND SIDE

A common view in microfinance circles is that interest rates do not matter to consumers: that micro borrowers do not necessarily understand the concept of rates, and that their demand for credit is anyway inelastic to the rate charged. However, in addition to the theoretical concerns outlined earlier about why the poor are willing to pay high credit rates, there is also a growing body of empirical findings about how sensitive the poor are to interest rate changes. The demand side evidence provides some answers to two key questions: Are the poor really sensitive to interest rates? And are they better off being served in a fringe, high interest rate environment, rather than being served only in the informal market? Again, we consider each question in turn.

Are the poor interest rate sensitive?

The microfinance resource center CGAP was an early champion of the view that poor consumers are not put off by high interest rates, with the implication that MFIs could and should indeed aim towards sustainability by increasing interest rates if necessary. This argument rests upon two

basic ideas. The first is that poor borrowers who are starved of capital should have high returns to investment and so should be willing to pay high interest rates. The second is that the poor already pay high interest rates to moneylenders and other informal providers, so loans at any rate lower than this should be welcome. (Rosenberg, 2002). Although others such as Attanasio et al, 2008 among others show that there may indeed be an unmet demand for credit, this does not necessarily mean that the poor are insensitive to interest rates, as the evidence below shows.

Bangladesh

Dehejia, Montgomery and Morduch (2005) examine a quasi-experiment in the slums of Dhaka to estimate interest rate elasticities. They collected data on the clients of an MFI called SafeSave, which opened three urban branches with slightly different interest rates. They found that a 1% increase in rates would result in slightly lower (0.73 to 0.88) percentage fall in lending volume; certainly not the inelastic response implied by insensitivity. Less wealthy households appear to be particularly sensitive to interest rate increases, so that a rates increase would tend to shift the MFI's loan borrower base away from poorest clients.

South Africa

Karlan and Zinman (2008a) conduct a field experiment with a large consumer lender in South Africa, using randomized direct mail offers with different interest rate scenarios to some 50,000 previous borrowers. They find that clients were sharply sensitive to rates above the lender's standard, and less sensitive to rates below this. They drew the conclusion that this lender priced appropriately—a decrease in price would not add much more volume and an increase in price would significantly lower take up. They also found that loan defaults rise as rates rise. They also point out that maturity may be a more crucial choice parameter for MFIs than rates. Similar interest rate experiments are currently being carried out in Mexico, Ghana and the Philippines.

United States

This recent finding from a developing country confirms an earlier finding from data on the U.S. credit card market. Gross and Souleles (2002) found a rate elasticity of debt outstanding of -1.3, even higher than found by Karlan and Zinman.

These results certainly indicate that poor borrowers are in fact generally sensitive to the interest rate.

Does credit at high rates make households better or worse off?

There are many studies which suggest that payday-type lenders take advantage of behavioral weaknesses in borrowers, encouraging chronic borrowing (as one example, see Stegman and Faris 2003), while others

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(such as Morgan 2007) find that payday lending is not necessarily predatory in the sense that it reduces the overall economic welfare of borrowers. Much of this evidence has been based on aggregate rather than client level data, and also comes from the application of correlational methods than strictly controlled experimental ones. Because it is very difficult to measure welfare impact, few comprehensive studies have attempted to answer this question which lies at the heart of whether to allow a legal high interest market. Fortunately, there is now evidence from several recent studies: based on the clients of U.S. payday lenders, of microfinance clients in India and of lenders in South Africa. Unfortunately for policymakers, the results point in different directions.

In the U.S., Skiba and Tobacman (2008) find evidence that use of payday lending hurts borrowers. They study the causal impact of access to payday loans on bankruptcy filing petitions, and they find that loan approval for first time applicants increases the bankruptcy filing rate by 2.48 percentage points. Moreover, this result is driven by consumers who are already financially distressed when they began borrowing on payday loans. They also show that approved applicants borrow repeatedly on payday loans and pawn broker loans. The cumulative interest burden from payday and pawn loans amount to roughly 11% of the total liquid debt burden at the time of bankruptcy filing.

In India, Banerjee et al (2009) analyzed the welfare impact on households in areas randomly serviced by a local microfinance institution. Interest rates on loans are about 20% APR and are disbursed via a group loan to between 6 to 10 women. The authors found that there was a difference in durable and non-durables expenditure, depending on whether borrowers were existing business owners, or had a high propensity to become business owners. Those with an existing business increased durable goods consumption. Those with a high propensity to own a business decreased non-durable consumption, i.e. consumed less in order to make the investment to become a business owner. Those who had a low propensity to own a business increased nondurable consumption. However, there was no effect from access to microcredit on measures of health, education or women's decision-making within a 15–18 month horizon, so whether microcredit results in welfare changes is unclear.

In South Africa, Karlan and Zinman (2008b) find evidence of positive impacts of consumer credit on borrowers. They use a random controlled experiment to assess the impact of liberalizing credit screening criteria on borrowers. In this experiment, the lender took applications for loans that had been marginally rejected and randomly approved them. Certain borrower indicators were then followed over the next two years. The results showed that expanded access to credit led to higher job retention by

borrowers over the study period, and also higher incomes, less hunger and a more positive outlook. There was also little impact on borrowers' credit scores—which appears to refute notions of an ongoing debt trap at least as a result of debt from formal lenders reporting to the credit bureaus.

Section summary

1. Evidence from both developed and developing countries indicates that poor borrowers generally are sensitive to interest rates.
2. Evidence on the impact of high interest rates on general household welfare is mixed: in the U.S. access to payday loans increased bankruptcy filings but South African consumer loan borrowers were better off overall.
3. On the supply side, the evidence shows that moral hazard associated with higher rates does affect the risk experience of lenders, but evidence from South Africa shows that adverse selection effects are less significant.
4. Evidence supports the view that the informal credit market is characterized by excess capacity, monopolistic competition and high average cost lenders.
5. The evidence is mixed on whether credit suppliers actually need to charge such high interest rates to cover the full cost of lending to low-income households.

Changing interest rate control regimes

CHARACTERISTICS OF INTEREST RATE CONTROL REGIMES

An interest rate control regime is more complicated than simply the choice whether to cap interest rates or not. In their 2004 Occasional paper, Helms & Reille distinguish three basic forms of interest rate ceilings based primarily on the source of authority for the ceiling.

- *interest rate controls*: these are usually found in banking or central banking laws and authorize the financial regulator to set maximum rates for regulated financial institutions, usually linked to monetary policy;
- *usury limits*: these are usually encoded into usury laws, which authorize a government body to establish some limit on rates for specified financial institutions;
- *de facto ceilings*: formal ceilings are not codified into law, but policy (such as government subsidized credit) or judicial activism keeps rates below a specified level.

Despite a trend towards liberalization, they identified forty developing countries with one or other of these forms of interest rate ceiling in 2004. These countries are listed in the table below.

Table 1: Current state of interest rate legislation for microcredit

INTEREST RATE CONTROLS	USURY LIMITS	DE FACTO CONTROLS
Algeria	Armenia	Brazil
Bahamas	Bolivia	China
China	Brazil	Ethiopia
Libya	Chile	India
Morocco	Colombia	Laos
Myanmar	Ecuador	Pakistan
Paraguay	Guatemala	Vietnam
Syria	Honduras	
Tunisia	Indian states	
UEAC	Nicaragua	
UMOA	South Africa	
	Uruguay	
	Venezuela	

Source: Based on Helms & Reille (2004) Table 3

However, the interest rate control regime has a number of important characteristics other than the source of authority for it. These include:

- *To which loans the ceilings do or do not apply:* it has become common in some but by no means all jurisdictions to make special provisions for ‘small’ loans of certain types; however, as Table 2 below shows for certain countries, the definitions associated with this vary widely—in terms of size or maturity of the loan, or even its purpose or usage (whether to start a microenterprise or not)

Table 2: Definition of qualifying small loans (or microcredit)

Columbia	Microcredit, which have the higher maximum interest rate (currently 34%), is defined as a loan under \$23,160 ⁴ to an enterprise with less than 10 employees or total (non-housing) assets under \$96,500. ⁵
South Africa	“Short term credit”, which can carry a 5%/mo. interest rate plus a fee of up to \$15 on a \$100 loan, is defined as a loan not exceeding \$800 and repayable within 6 months.
United States	Of the 38 jurisdictions with small loan enabling legislation (thereby allowing rates and fees exceeding the otherwise applicable state usury rate): <ul style="list-style-type: none"> • 29 set a maximum loan amount between \$300–\$700; • another five set the maximum between \$1,000–\$2,500; and • the other four have no maximum.

- *What is capped:* some jurisdictions cap only the interest rate while others also include related fees (which might otherwise be charged as a means of avoiding the rate cap).
- *How the cap is applied:* some jurisdictions impose an absolute cap while others merely set a methodology for calculation linked to a benchmark rate. As an extreme example of the former, the U.S. state of Arkansas enshrines a maximum interest rate of 17% in its constitution. By contrast, the regulations promulgated in terms of the South African National Credit Act provide for a formula linked to a Central Bank determined rate which changes frequently (see Case 3 below). More common, however, are the in-between cases where a regulator has discretionary authority to reset the maximum rate; whether and when he chooses to do so as market conditions change will have a large impact on whether or not the cap is in fact binding. For example, in Colombia (Case 1 below), the banking association complains that the cap has not been reset in line with market conditions as was intended.

4. It is set at 120 times the statutory minimum monthly wage. This minimum monthly wage is COP 433,700 (2008).
 5. This is equal to 500 monthly minimum wages. See prior footnote for additional calculation details.

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Policy Framing Note 4: Interest Rate Policy

- *Whether or not the cap is in fact binding on credit players:* the level at which a cap is set, and reset as conditions change, affect whether or not it is in fact a constraint on the provision of microcredit or small loans in general. For example, the reduced level of the new cap set by the Japanese Parliament for consumer credit has caused widespread change in the lending sector there (see Case 2 below). When South Africa re-imposed a cap on small loans effective from 2007, maximum rates were established in most categories of credit which were well above market norms (and linked to a benchmark so they would automatically recalibrate over time), but in very short term loans, the ceiling was set well below market norms then prevailing.

The complexity of most capping regimes creates the opportunity for regulatory arbitrage by lenders: introducing new types of loan products⁶ or pricing schemes including fees which are not subject to the caps. In some jurisdictions, caps which applied only to regulated institutions (such as banks) encouraged the entry of new lenders which did not take deposits and hence were not subject to the caps; in fact, in some countries, the early growth of NGOs offering microfinance was for this reason. Equally, changes in the rate regime can likewise have unintended consequences: the exemption to the South African Usury Act introduced in 1993 was intended to promote lending to microenterprises but the exemption did not attempt to distinguish loans by usage and instead exempted all loans below a size and maturity threshold. The result was primarily to enable the growth of a large, formal consumer lending sector which focuses on salaried employees (Porteous & Hazelhurst 2004).

INTEREST RATE REGIME CHANGES

Goldsmith (1969) and others have made a strong case that interest rate controls set at too low a level create financial repression, negatively affecting financial intermediation and growth. However, it is in fact hard to separate out rigorously the full effect of the interest rate control regime. Because U.S. states differ in their interest rate control regimes yet are similar in at least some other basic ways, they have been used as a basis for cross-sectional analysis of the effects of interest rate controls.

Analyzing the experience of interest rate ceilings for the UK's Department of Trade and Industry, Policis (2004) looked at the 50 U.S. states, and concluded that the main effect of rate ceilings was to restrict the diversity of products available and the ability of lenders to innovate with loan products targeting different segments. (§ 4.1(i)) Policis also noted that, in markets without ceilings and where subprime product diversity and competition was most visible, interest rates had tended to move downwards overtime (§ 2.2(xi)). In general, volumes of payday lending grew rapidly during the period 1998–2003 in the twenty-eight states expressly enabling the practice.

6. As one example, consumer lenders in the US in early 20th Century argued that they were in fact buying salaries in advance from employees, rather than lending.

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Viewed over the long term, the rate regimes across the U.S. states reflect the general trend towards liberalization of credit markets and in favor of creating special dispensations for small loans, at least until recently. As Lendol Calder (1999) describes in his history of consumer credit, *Financing the American Dream*, most U.S. states had a binding usury ceiling (typically 6%) at the start of the 20th Century, although there was widespread evasion of the law. Following an extensive research process led by the Russel Sage Foundation, which inter alia included experimentation with the rate at which small loans could be made sustainably by non-profit lenders, the Uniform Small Loan Law was adopted in New York and then in two other states by 1917. This law allowed for rates of up to 3.5% per month (but no fees) on loans of less than \$300.

Fast forwarded to 1998, 20 states specifically allowed payday lending. This number rose further to 34 by 2001 and 37 by 2004.⁷ At 41 in October 2008, it may have peaked: *The Economist* magazine reported on decisions in three states in November 2008 (two referenda and one court decision) which will have the effect of closing down payday lending in those states reducing the count to 38.⁸

On an international level, even in 2004, Helms and Reille noted signs that the policy winds were shifting on this issue: a presidential decree in 2004 in Bolivia, the early home of pioneering microfinance, placed interest rate ceilings on small loans; and similarly, the state apex lender to the microfinance sector in Bangladesh, PKSF, imposed a contractual cap of around 24% APR on the retail rates which could be charged by MFIs which borrowed from it from 2005. Since then, Japan has effectively ended its special rate dispensation for small consumer loans (see Case 2 in the Appendix), South Africa ended in 2007 the rate exemption for small loans which had existed since 1993, and, in a remarkable move for a country long characterized by state prerogative on this issue, the U.S. federal government imposed a rate cap on payday loans to military personnel in 2007 (see Case 4). However, while these changes may indicate that the trend towards liberalization is changing, not all changes in the past four years have been towards tightening rate control: in Colombia, a special rate dispensation was created for microcredit in 2007, although the application since then has generated some ambiguity over the strength of the intent of government towards liberalization (see Case 1). These four recent cases, each different in their scope, rationale and potential impact, are summarized in Table 3 below.

7. Calculated from Table 1 in Flannery and Samolyk, updated with information from www.paydaylending.com
8. "Casting out the money-lenders", Nov 20th 2008
The Economist available via http://www.economist.com/world/unitedstates/PrinterFriendly.cfm?story_id=12641615

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Table 3: Recent changes in interest rate regime

JURISDICTION	DATE	NATURE OF CHANGE	REASONS FOR CHANGE AND IMPLICATIONS
1. Columbia	2006 (effective 2007)	Introduces a specific ceiling (34%) for microloans as defined higher than the general ceiling (plus 7.5% allowed for fees since 2001)	A desire to promote access to credit has resulted in partial liberalization of the ceiling to encourage microcredit specifically, although the implementation of the new ceiling has not been updated to reflect changes. Nonetheless, there has been a substantial increase in microcredit from private banks over the past few years.
2. Japan	2006 (effective 2009)	Lowers maximum rate to 20% for consumer lending	Public pressure following court decision finding higher rates unlawful; and public outcry over bad lending practices of certain consumer lenders. This change has already caused major changes in the consumer credit sector, including consolidation and failures of smaller lenders.
3. South Africa	2005 (effective 2007)	Removes exemption from ceiling for small loans; and introduces cap at 5% per month for short term loans as part of an integrated credit framework	After more than a decade in which there was no ceiling on small loans, a review of the entire credit framework resulted in repealing the obsolete Usury Act and introducing instead a unified framework of consumer credit regulation in which provision is made for differential caps based on loan size and usage.
4. United States	2007	Introduces a rate cap of 36% p.a. (including fees) on certain categories of short term loans to military personnel	Evidence gathered by Department of Defense that predatory activity was directed at military and that this undermined families and military readiness.

In all of these cases, it is too early to judge the full implications of the change. However, the available evidence suggests that there is at least one clear effect of a change in rate regime: it has a strong signaling impact on private sector credit providers, affecting their supply of credit. For example, the tightening in Japan has led to restructuring of the consumer credit sector, reducing supply; but on the other hand, the loosening of rate restrictions in Colombia has been at least one reason behind the increase in the volume of microcredit extended there. Clearly, the power of the signal sent by a change in regime depends on how credible the change is: in the Japanese case, a court decision followed by an amendment in the law made clear that the lowered ceiling was permanent, and consequently triggered structural changes in both large and small providers. On the other hand, the application to date of the Colombian liberalization decree has sent to Colombian banks mixed signals of the government's willingness to support the case for high rates to the poor.

The cases above also differ as to the impetus for the policy change in each case: the cap on loans to military personnel in the U.S. followed a Defense Department review of the effects of borrowing among soldiers and their families; and the new South African credit framework introduced in 2005 followed a formal Credit Law Review process lasting several years which considered a broad range of factors including the historic denial of credit to sections of the population who were otherwise creditworthy, and subsequent abuses when this changed post-apartheid. The resulting South African National Credit Act states explicitly its objectives of increasing credit access and avoiding exploitation. Similarly, the Colombian decree aimed explicitly to improve access to credit for micro entrepreneurs as part of the government's anti-poverty and growth strategy. In Japan, the Parliament took prompt action following a court case which had introduced material uncertainty and linked to a public outcry over bad practices (note, not rates per se) of consumer lenders.

While over time, we will come to understand better the effect of the changes in these four cases, we can not measure the full impact because of the absence of a counterfactual—a common problem with policy changes. However, the variety of interest rate regimes across the U.S. states offers the basis for at least some level of impact assessment about regime changes. Morgan and Strain (2008) take advantage of a natural experiment in Georgia and North Carolina where payday loans were banned in 2004 and 2005 respectively. They found that, compared with states where payday lending is permitted, households in Georgia bounced more checks, complained more to the FTC and filed for Chapter 7 bankruptcy at a higher rate after the change. Similar results were found for North Carolina. They conclude that payday lending, rather than being predatory, compares favorably to a close substitute: bounced check protection, where clients pay a fee to the bank to avoid the embarrassment of having a check returned unpaid.

Section summary

1. Rate ceilings in the U.S. had the effect of hindering innovation and development of loan products targeting different customer segments.
2. Changes in a rate regime have a strong signaling impact on private sector credit providers and can lead to major changes and restructuring within the sector.

Policymaker's toolkit

Good policy starts with a clear objective, or at least a clear statement of the specific problem to be addressed. In credit markets, as the preceding sections have showed, this is not easy to do: not only are the causes of the different problems which beset credit markets hard to distinguish empirically, but the political hyper-sensitivity attached to credit market issues in many places means that policymakers often have little time or space for deeper analysis when controversy erupts, as it did in Andhra Pradesh in 2006.

Commonly encountered problems with retail credit markets may include the following, all of which have characterized one or more of the markets which were the subject of the cases cited:

- A lack of access to credit, especially among particular lower income and/or higher risk borrower groups such as small business or poor households (South Africa, Colombia);
- Perceived or actual abuse or exploitation of particular groups of borrowers (the military in U.S.), which may be generalized or specific to particular practices (collection practices of consumer finance companies in Japan);
- Over-indebtedness of sufficient numbers of people to warrant concern (clients of consumer finance companies in Japan, military in U.S.), which may be distinct from abuse by lenders, since it may result from reckless borrowing by consumers;
- Linked to or separate from over-indebtedness, concerns over a “credit bubble” which could burst with larger consequences for the stability of the financial system;
- Interest rates at “unconscionable” levels or else “too high” to be affordable for particular groups: this is often the allegation leveled by politicians for example, in India or in Bangladesh in 2004 where the then Minister of Finance described microfinance interest rates as “ridiculous”, “absurd” and “extortionate”.⁹ Courts have also exercised discretion in this respect. In addition to the Japanese case, even though the Central Bank of the Philippines had suspended the usury ceiling in 1983, the Philippines Supreme Court asserted in a December 2006 case that interest rates may still be found illegal if they are “unconscionable”. In their decision on the case before them, the court reduced rate of interest from 36% per annum interest to 12%, deeming a rate of 12% per annum “fair and reasonable”.¹⁰ In India, a similar matter is about to reach the Supreme Court: the National Consumer Disputes Redressal Commission issued a decision in 2008 imposing a 30% rate ceiling on

9. Quoted in Wright and Alamgir (2004) p.12

10. *Macalalag v. People of the Philippines*, G.R. No. 164358, December 20, 2006.

bank-issued credit card debt, despite the power to set bank interest rates vesting in the Reserve Bank of India (RBI) overriding the RBI's express policy to not place any ceiling on interest rates.¹¹ The decision is now on appeal to the Supreme Court.

It is of course possible to have multiple problems simultaneously in the same market—for example, a lack of access among some groups, such as microfinance groups, and over-indebtedness among others such as civil servants or salaried workers—even though each has a distinct cause and set of solutions. Clearly, the definition of problem will define the possible tool set to address it. Interest rate policy is only one tool in the kit, although it is the focus of this note: other tools such as consumer protection or prudential regulation measures or competition policy have been addressed in other Framing Notes and will not be described in detail here. Instead, we will restrict the toolkit to three tools directly related to interest rate policy.

The last complaint above—that interest rates are simply “too high”—is commonly heard, but it is the odd one out. Compared with other problems such as abuse or over-indebtedness which can be defined and measured more clearly, it is the most subjective (what does “high” mean?); and even if it is defined in terms of resulting in excess profits to lenders, it is a symptom of a range of possible deeper problems in the credit market.

CREDIT MARKET INFORMATION

Consequently, an essential tool for policymakers is an accurate, up to date measure of trends in rates and volumes across key lending sectors. It is in fact not easy to measure interest rates in a particular segment over time. This requires first, the disciplined collection of data from a sufficiently wide group of lenders within a defined product range, which may be harder than it seems since the small loan sector may be unregulated, hence with no basis to compel reporting, or even if regulated, may comprise thousands of small firms from which data must be sought. Second, the individual rates must be weighted using some measure of lending volume (which must therefore also be collected) in order to produce a meaningful market average rate.¹² For a study of the effect of competition in three pioneering microfinance markets, Porteous (2006) reports that primary data had to be collected from large lenders in two of these markets, Bangladesh and Uganda, while in the third, Bolivia, it was possible to draw on an industry study which had produced long run reliable data back to 1992.

However, using average nominal rates alone may be misleading: they could be high because of inflation or because the general pattern of lending rates in the country was high. Therefore, to get a true sense of trend over time, the interest rate in a segment such as microcredit should be reflected in real terms, and also relative to the general pattern of bank

Interest rate policy is only one tool in the kit, although it is the focus of this note: other tools such as consumer protection or prudential regulation measures or competition policy have been addressed in other Framing Notes.

11. India National Consumer Disputes Redressal Commission, Case No. 51 of 2007, Memorandum of decision, July 7, 2008.

12. This process of setting ceilings based on weighted market rates is in fact the process followed by financial regulators in Colombia, supposedly annually.

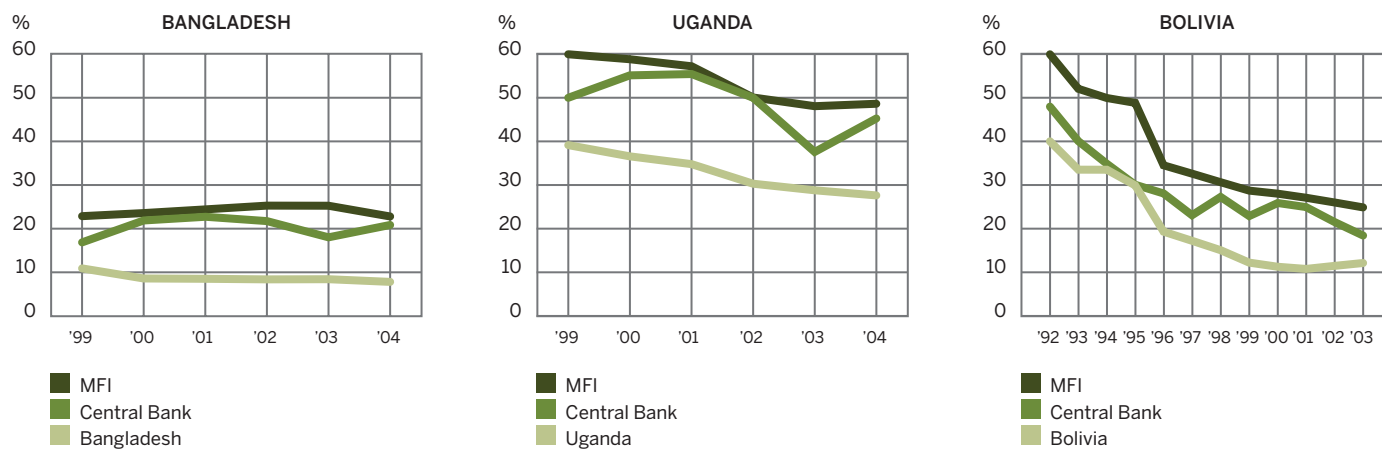
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lending rates, as reflected say in the bank lending rate captured by central banks as part of monetary policy information. These three different rate time series are shown for these three countries below.

Microcredit had been possible and generally available in each of these three countries for a considerable period prior to this data without any rate caps. However, the absence of caps is clearly not sufficient to lead to competitive declines in rates: Bolivia alone shows clear evidence of a long term decline in rates by all three measures, even prior to the imposition of a cap there in 2004. In Bangladesh, despite the large scale and reach of the microfinance sector, average rates had changed little in five years in the absence of any cap, while in Uganda there was some early evidence that declines had started as microlending became more commercial and competitive.

Figure 1: Microcredit interest rates over time in three pioneering markets



Source: Porteous (2005)

The absolute level of rates differs enormously across these countries, as does the differential between microfinance and bank rates in each: from more than 30% in Uganda to less than 10% in Bangladesh. Clearly, in assessing whether rates are high in a particular country, cross-border comparison of nominal rates alone makes little sense, but monitoring the trend within the country over time is indeed an important indicator for policymakers to consider. However, the evidence of the trend alone does not provide a guide for interest rate policy: for example, if rates remain stuck at levels which appear to generate high profits to lenders, further information must be collected to determine the causes. If the problem relates to information asymmetries, then first best policy measures to address the cause would include promoting the use of information coordination mechanisms like credit bureaus. If instead the problem is caused by an uncompetitive market structure, then measures to promote competition should be considered, including as compulsory credit bureau

reporting to encourage transferable credit records (as in Japan and UK) and to encourage transparency of price and terms and awareness by borrowers (as discussed in 3.3 below). Even if the problem is caused neither by a lack of competition nor by information asymmetry, it is quite unlikely that a “problem of high rates” will be solved by the introduction of a rate cap alone.

INTEREST RATE CEILINGS

The previous section explained that the interest rate control tool is in fact a complex multi-faceted tool involving many choices of what to limit and what not to limit, and how to do this. The limited evidence of the effect of changes in interest rate ceilings—whether relaxations as in Colombia or re-impositions of ceilings in different ways and to differing extents in Japan, South Africa and USA—suggested that the tool can have a powerful effect at least on market participants. Should the interest rate ceiling remain in the modern policymaker’s toolkit?

Helms and Reille (2004) present the mainstream microcredit view when they argue for the removal of binding ceilings on small loans:

“...interest rate ceilings...can hurt poor people. The ceilings discourage the provision of tiny loans by making it impossible to recover the high administrative cost of such lending. When a ceiling cannot be rigorously defined and enforced moreover, an unintended side effect may be to reduce transparency about a borrowers’ true cost. ...The best way for governments and donors to reduce interest rates without making microcredit unsustainable is to promote competition and innovation, both of which improve competition and lower prices.” (p14)

Traditional arguments for the removal of interest rate ceilings at least for small loans (since ceilings seldom are binding for large loans) include:

- They deny poorer or riskier borrowers access to mainstream formal credit, and may make them worse off: in particular, borrowers with riskier profile or smaller loan sizes who are thereby denied access to formal credit may end up paying far more than the ceiling for loans from informal lenders with no protection from the law at all;
- They are usually hard to enforce: the complexity involved in the calculation of rates and understanding credit terms means that hard pressed enforcement agencies pay little attention to these laws;
- They are often relatively easy for providers to evade through altering product terms or charges, but the process of arbitrage is inherently socially inefficient and may create incentives for unregulated entities to emerge and grow which merely transfers the problem out of the domain of the original regulator which set the ceiling;

- They stifle credit product innovation and finer market segmentation by confining the acceptable range of rates and products;
- They may have perverse consequences, such as signaling a maximum acceptable rate in such a way that, even if the ceiling is non-binding, privately set interest rates may cluster at or near the ceiling level in certain niche markets such that the competitive pricing mechanism in those niches is undermined.

All these arguments against ceilings remain compelling in theory at least. In practice, removing a rate ceiling without taking other measures to develop the credit market and protect consumers no more assures that all these issues will be addressed than imposing or re-imposing it means that the other problems listed earlier (such as abuse and over-indebtedness) will be solved. An interest rate control regime is an embedded aspect of many credit markets; and changes to ceilings in either direction must be done with care. As the recent court decisions in India, Japan and Philippines have indicated, courts may step in to wield the tool of rate ceilings even if they are not part of current law or practice. While it may therefore still make sense for policymakers to relax rate ceilings which restrict small loans in a phased approach over time, the evidence at least suggests that it may be counterproductive and unsustainable to remove ceilings altogether without taking other effective measures to ensure that credit markets can integrate and develop over time, and that consumers can be protected

RATE DISCLOSURE

The first section of this note presented evidence that small borrowers are in fact responsive to interest rates, whether or not they fully understand the concepts of compound interest and the different ways of calculating them. A traditional policy tool both to prevent abuse and promote competition has therefore been to encourage transparency about rates (and other terms) *ex ante*. Because of the complexity involved in calculating and comparing rates, policymakers have tended to settle on a few standardized measures of the cost of borrowing:

- Total Cost of Credit (TCC): this includes all the costs associated with a credit contract: not only the amount of interest but a range of ancillary charges for services linked to the credit (such as initiation or servicing fees and payment protection insurance)
- Annual Percentage Rate (APR): the TCC expressed as an annualized percentage of the total amount of credit; and
- Total amount payable (TAP): the 2008 EU Consumer Credit Directive, effective from 2010 in member states, has added this concept to all required disclosure: which adds the amount of credit to the TCC.

An interest rate control regime is an embedded aspect of many credit markets; and changes to ceilings in either direction must be done with care.

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In fact, the calculations of TCC and especially APR require numerous assumptions and can be quite complex: the UK's credit regulator, the Office of Fair Trading, has published a guide to the calculation of credit charges and APR, which is 58 pages long.¹³

Apart from standardized calculation, regulation has become increasingly prescriptive with regard to standardizing the disclosure of rates. As Box A below explains, in 2000, thirty-two years after the original truth in lending law was passed, the U.S. adopted the so-called "Schumer Box" as a means of standardizing simple disclosure of the terms of credit card agreements, including specification of the font size, as shown in the example which follows. Other jurisdictions adopt similar practices: for example, the UK's OFT published in 2008 a 35 page guidance note covering all credit advertising, defining what must be disclosed, when and how: as with the Schumer Box, it requires that the APR must be more prominent than any other rates displayed.¹⁴

Box A: The "Schumer Box"

In 1968, the Truth in Lending Act (TILA) was enacted in the U.S. TILA is a federal law applicable in all states. TILA, first passed in 1968 as a part of the broader Consumer Protection Act, applies to all consumer credit and is designed to protect consumers by requiring clear disclosure of the key terms (including all costs) of the lending arrangement. In 1988, the Fair Credit and Charge Card Disclosure Act was passed, as an amendment to TILA, requiring that all credit card solicitations provide terms and conditions in a "clear and conspicuous manner" and in tabular form. However, the Federal Reserve Board—the government agency responsible for implementing the purposes of the law (via issuing its Regulation Z)—failed to define what exactly "clear and conspicuous" meant. This resulted in disclosures which continued to be confusing. In 2000, the so-called "Schumer Box" provision, named after Senator Charles Schumer who advocated for it, went into effect throughout the U.S. when the Fed issued a rule change to credit card disclosure regulations, requiring a minimum font size of 18 point for the long-term interest rate and 12 point for the following terms and conditions (see example Figure 2 in the Appendix below): APR for purchases and other transactions, variable rate information, grace period, finance calculation method, annual fee (if applicable) and other transaction fees. The particular Schumer Box provision applies only to credit cards. According to Senator Schumer (in 2000), "because of ambiguous regulations, consumers have lacked the information they need to comparison shop. These new regulations do not tell credit card companies what their rates should be, but require them to clearly inform consumers of the rates they charge."¹⁵

Does greater mandated disclosure in fact help? The evidence that better disclosure leads to better outcomes for consumers is sketchy, but, in general, the answer seems to be yes.

Various studies have found that consumers claim to take into account the interest rate in credit decisions: in the UK, the MORI "Consumer awareness of credit issues" study conducted for Department of Trade and Industry in 2003 found that the APR in an important factor in the choice of credit offering. In South Africa, the nationwide FinScope survey (2006) shows that the interest rate is the second most common factor cited by 22% of borrowers in determining where to take a long term loan. These findings are backed up by qualitative evidence that suggests that

13. Credit charges and Apr available via http://www.offt.gov.uk/shared_offt/business_leaflets/consumer_credit/oft144.pdf

14. Credit advertising, OFT August 2008, APR issues are addressed specifically on p.29. http://www.offt.gov.uk/shared_offt/business_leaflets/consumer_credit/oft016.pdf

15. Senator Charles Schumer, Press Release, May 18, 2000.

transparency in price could be even more important than price itself. The Financial Diaries, a year-long study of low income financial management in South Africa, include a woman who had informal credit obligations at several informal merchant shops (see Collins et al, 2009 for this example and others from Financial Diaries in Bangladesh, India and South Africa). Each month, after she paid what she thought was her outstanding balance at these shops, she would be told that she still had debt outstanding, but, without any knowledge of how much interest was being charged, she didn't know if she was being charged unfairly. Finally, in frustration, she took a loan from an informal moneylender at a very high monthly rate of 30% to pay off all of her shop accounts. At least, she said, she knew how much she was being charged by the moneylender.

Borrowers may report that they are aware of interest rates, but insights from behavioral economics suggest that awareness, or even understanding, of credit terms is not enough to prevent abuse. Traditional neoclassical economics assumes a rational consumer who will search all available options until the search costs exceeds the marginal benefits of lower cost, but behavioral economics takes into account the limitations in how borrowers process information. For example, consumers may suffer from information overload, as a result of which at some point they stop including more information in their decision-making. The DTI's MORI research backs this up: around 40% of borrowers only read the main information on the front page of an agreement before signing. Hence the logic of simplified ways of displaying essential information such as the Schumer box.

Further recent evidence, based on behavioral ideas, suggests that enforcement of disclosure laws does in fact make a difference to the amount of interest paid by the most susceptible consumers. Stango and Zinman (2007a) propose that consumers underestimate the interest rate implied by the loan amount, maturity and stream of monthly payments.¹⁶ Improved disclosure may help mitigate this bias. Following a change in U.S. law in April 1981 which reduced penalties and generally weakened the enforcement of TILA, they found that households with greater tendencies to underestimate rates pay roughly 300–400 basis points more when borrowing from lightly regulated lenders. Mandated and enforced interest rate disclosure can therefore prevent lenders from exploiting this particular cognitive bias in how consumers perceive interest rates.

In general, therefore, the available evidence on requiring and enforcing disclosure of rates and other credit terms suggests that this is a useful tool, especially if simple and consistently enforced.

Borrowers may report that they are aware of interest rates, but insights from behavioral economics suggest that awareness, or even understanding, of credit terms is not enough to prevent abuse.

16. This is explored more fully in a companion paper of Stango and Zinman (2007b) where they use a quiz question from the 1983 Survey of Consumer Finance asking respondents to estimate an APR and find a systematic downward bias.

Section summary

1. Evidence suggests that it may be counterproductive and unsustainable to remove an interest rate ceiling altogether without taking other measures to ensure that dualistic credit markets can integrate and expand over time, and that consumers can be protected.
2. Policymakers need accurate, up-to-date measures of levels and trends in interest rates and lending volumes. This requires regular collection of broad data and the calculation of a meaningful average market rate.
3. Policymakers need to go beyond monitoring trends to determine the causes of interest rates appearing stuck at high profit-generating levels.
4. Evidence suggests that enforcing disclosure of rates and other credit tools is a useful tool.

Conclusion: Navigating the dilemma

The policy dilemma around interest rates is age-old, yet recent research has helped to refine understanding of the effects of interest rates on borrowers; and in particular, of their biases which can be exploited by lenders.

Microfinance has grown up making the case that interest rate caps are obsolete and often harmful to the poor. Removing binding caps on certain small loans is still likely to be part of the solution to the problem of widening access to credit. But, as microfinance has come of age, so the evidence has accumulated that the wholesale liberalization of credit markets is not necessarily a long term solution either: price decontrol may well cause a powerful supply response as lenders enter new market niches. which may help to broaden access to credit rationed groups in the short run; but in the absence of appropriate consumer protection measures and enforcement, this situation may be unsustainable as evidence of abuse grows or if chronic widespread over-indebtedness results. Even if price control itself does not address the roots of the problem, following a political or judicial backlash, price control is likely to be hastily re-imposed along with other measures which may damage the growth and development of credit markets.

Any changes in credit policy must be made with care for three reasons outlined in this Framing Note:

1. The now well-known informational imperfections of credit markets,
2. their enduring political and social sensitivity in many places, and
3. the new evidence that borrowers have cognitive biases which lenders can and do systematically exploit.

Care is especially necessary with changes in the interest rate control regime. Changing the rate ceiling may be inadequate on its own to lead to increased access to credit and may have unintended consequences. Nevertheless, interest rate control remains *de facto* a tool in most policy maker's toolkits: as we have seen, even when usury-type laws have been suspended or enforcement has lapsed, courts and tribunals in countries from Philippines and India to the UK have continued to rule on what constitutes fair and proportionate rates. Nonetheless, the evidence presented here suggests that the interest rate control regime in itself will certainly not prevent over-indebtedness or borrower exploitation, though it may reduce the scale of abuse, by limiting the scale of legal formal credit operations in high risk niches.

Other more targeted tools should be used to address those ills. Rather, the interest rate control regime appears to have particular value as a means of signaling a policy stance to credit providers around certain market niches and type of borrower: maintaining or imposing a binding ceiling signals a concern about borrower abuse and an inability to prevent it; relaxing a binding regime in particular ways signals a willingness to support private sector engagement in these areas. As credit markets evolve, so too must any interest rate control regime. If policymakers wield this oldest of credit policy tools carefully, and keep it sharp and relevant to current credit market conditions, it may yet remain a useful tool; one tool of many to be sure, but sometimes a useful tool regardless.

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NOTE ON FOREIGN CURRENCY CONVERSIONS:

Rates used were prevailing as at 31 December 2008:

1US\$=10 ZAR; 1US\$=50 INR; 1US\$=2250 COP.

Appendix 1: Four cases of interest rate regime changes

Case 1: Columbia raises the Interest rate ceiling for microcredit

Colombia has a general interest rate ceiling in the form of a specified usury rate. Over the past decade, the interest rate policy has materially changed three times: the first change (1999) lowered the ceiling, while the two most recent changes (2001 and 2007) each increased it for microloans at least.

At the end of 1998, the interest rate ceiling was 42%. In 1999, the government changed the usury definition: it now set the usury limit as 1.5 times the weighted average interest rate on commercial loans of less than a year. No distinction was made for microcredit loans, and this new definition resulted in a ceiling of approximately 18% at the beginning of 2000 (WWB 2005).

In 2000, Law 590 (also referred to as the MIPYME law) established the Microfinance Council and created the space to charge fees and commissions to cover microlending transaction costs. In 2001, this Microfinance Council issued a regulation which allowed microlending fees (to cover administration costs) of up to 7.5% (per annum) to be charged, in addition to the interest rate, in effect, increasing the ceiling.

By 2004, due to movements in the underlying benchmark rates, the interest rate ceiling (still applicable to all forms of credit) had risen to approximately 26%, to which the 7.5% fee could be added (ACCION 2004).

By Decree 4090 of 2006, the financial sector regulator (Superintendencia) was empowered to certify an interest rate ceiling for microcredit that is distinct from the ceiling applicable to other commercial or consumer credit loans.¹⁷

The formula still involves multiplying the average microcredit market rate by 1.5. The ceiling is supposed to be set once per year, but the maximum rate first certified for the period April 2007–March 2008 (34%)¹⁸ has been extended for an additional year (through March 2009), even though the market rate (multiplied by 1.5) would yield a substantially higher rate, estimated by Asobancaria in March 2008 to be approximately 46%. According to Asobancaria, this failure to move the usury rate in line with the market is restraining further expansion of microcredit. In addition, this apparently arbitrary extension of a rate established based on market conditions from almost two years ago brings a degree of detachment from market reality, as well as a degree of uncertainty, to Colombia's microcredit market.

Microlending has increased substantially in Colombia in the past few years: the aggregate outstanding loan portfolio to microenterprises (including that from banks, commercial finance companies, credit unions and NGOs) grew 74% in the period from mid-2006 (\$2 billion) to November 2007 (\$3.4 billion)¹⁹. This includes an estimated 600,000 people who previously had no access to formal credit, and who probably used to tap into informal money-lenders charging rates well above the stated usury rate (Asobancaria March 2008). However, it is not possible to attribute the expansion in microcredit to the increased interest rate ceiling alone because there have been other positive influences introduced over the past six years that also support the trend, including subsidies from Banca de las Oportunidades, measures to promote basic bank accounts and allowing bank correspondents.

17. Although not impacting microcredit, while this same Decree 4090 provided for rates to be certified distinctly for regular commercial credit and consumer credit, this distinction was subsequently eliminated by Decree 519 of 2007. According to Asobancaria, this blended rate has served to constrain consumer credit; and it argues for the distinction to be reintroduced (Asobancaria November 2008).

18. If the 7.5% administration fee allowance is added, the effective interest rate ceiling here would be 41.5%.

19. Bancoldex Annual Report 2007, pp. 13–14.

Case 2: Japan reduces the interest rate ceiling on consumer lending

In December 2006, the Japanese Parliament revised the Money Lending Business Law, reducing the maximum interest rate permitted on unsecured loans from 29.2% to 20%. While Japan has a Usury Law dating from 1954 which caps rates at 20%, an amendment in another law (Investment Deposit Interest Rate Law) in 2000 had permitted interest rates on consumer loans of up to 29.2% as long as written borrower consent was obtained in this so-called 'gray zone' (20–29.2%). A thriving sector with some 14,000 mainly small consumer finance companies developed, specializing in loans with rates in the gray zone. The 2006 change in the law followed a Supreme Court ruling earlier that year against a major CFC, finding that any interest charged above 20% was in fact illegal. Public perception had been further riled against consumer lenders due to much publicized regulatory action taken by Japan's Financial Services Agency against one of the largest consumer lenders, requiring it to cease abusive collection practices, such as calling borrowers at their workplace, and suspend operations for three days.

In addition to the effective lowering of the usury ceiling, the amendment established a designated credit bureau for consumer finance companies and placed a limit on the total amount of consumer debt which an individual can assume. The changes to the law come into effect only in late 2009; however, the court finding has already caused major changes in the sector which "...is expected to shrink by as much as a third, according to some estimates. The changes were enough to lead even the largest consumer finance companies to adopt wide ranging restructuring measures to cut costs and have forced weaker players to cut back their operations massively, if not close their doors or seek survival in a merger with a stronger rival."²⁰ Fears have been expressed that small businesses, often reliant on short term finance from this source, would be forced to rely on informal loan sharks instead; although other commentators have expressed the view that the changes will encourage mainstream banks to take the consumer credit market more seriously. "The size of the consumer finance sector is likely to contract sharply but the restructuring of the industry should improve efficiency"²¹

Case 3: South Africa reintroduces a rate cap on small loans

Intending to encourage microcredit, the Minister of Trade and Industry responsible for the Usury Act in South Africa signed into law in 1993 an exemption to the Act. This exemption removed small loans (those less than US\$1000) from the effect of the prevailing interest rate ceiling set in terms of the Act. This single change led to explosive growth in the microcredit sector, largely targeting salaried borrowers (Porteous & Hazelhurst 2004). Concerns over mounting abuses under the exemption led to successive tightening of control over lending practices under a regulatory regime which applied only to lenders wishing to enjoy the benefit of the exemption. Then, after some years of deliberation, the country's entire consumer credit framework was overhauled, resulting in the passage of the National Credit Act of 2005. This Act scrapped the price exemption on small loans, but instead, gave to the responsible Minister the power to prescribe maximum rates of interest and fees but required that in so doing, the Minister must consider the a range of factors: the need to increase access to credit to groups previously denied it; conditions in the credit market and the social impact on low income consumers (Section 105). In addition, the Act provides for different ceilings for different defined subsectors of the credit market; and requires the Minister to re-evaluate formally the impact of the rate regime every three years based on a report from the National Credit Regulator.

Regulations in terms of the new Act recognize seven credit subsectors with differential rate maxima, each linked to a benchmark rate set by the Central Bank, rather than periodic changes as before; and with associated fees also capped with effect from 1 June 2007, with current maxima varying from 30.3% on mortgages to 45.3% on developmental credit. It is noteworthy that the ceiling for rates and fees on developmental credit are the highest outside of short term credit.

20. "Industry tries to shed its murky image" *Financial Times* 14 September 2007 Michiyo Nakamoto

21. "Japan pursues consumer finance reform", *Oxford Analytica* 08/21/07 via www.forbes.com/2007/08/20

FINANCIAL ACCESS INITIATIVE POLICY FRAMING NOTE

Policy Framing Note 4: Interest Rate Policy

Case 4: The US introduces caps on short term loans to military personnel

In October 2007, the Military Lending Act went into effect throughout the US. This is a federal law applicable in all states, and is an exception to the general rule in the US where interest rate policy is determined at state level.²² The law caps interest at 36% pa (including fees) for certain payday, auto title, and refund anticipation loans made to military personnel and certain of their family members. It applies only to loans of 91 days or less, and prohibits lenders from holding onto the military member's personal check or having electronic access to their bank account as collateral for this type of loan. The legislation was enacted following issuance by the Department of Defense of a Report on predatory lending practices directed at members of the Armed Forces and their dependents (August 2006). The Report states "predatory lending undermines military readiness, harms the morale of troops and their families, and adds to the cost of fielding an all-volunteer fighting force."

Appendix 2: An example of a Schumer Box (including font sizes)

	Disclosures
Annual Percentage Rate (APR) for purchases	11.99% variable
Other APRs	Balance transfer APR: As long as first balance transfer is completed within 9 months from date of account opening, 0.00% for 9 months from date of first balance transfer. After that, 11.99% variable. Cash advance APR: 20.99% variable. Default APR: 29.99% variable. See explanation below.*
Variable rate information	Your APRs may vary each billing period. ** The purchase and balance transfer APR equals the Prime Rate plus 5.99%. The cash advance APR equals the Prime Rate plus 14.99% (never lower than 19.99%). The default APR equals the U.S. Prime Rate plus up to 23.99%.
Grace period for repayment of the balance for purchases	At least 20 days if you pay the total balance in full by the due date every billing period. If you do not, you will not get a grace period.
Method of computing the balance for purchases	Average daily balance. This includes new purchases.
Minimum finance charge	50 cents.
Annual fees	None.
Other fees	Balance transfer fee: 3% of each balance transfer; \$5 minimum. There is no fee with the 0.00% APR balance transfer offer described above. Cash advance fee: 3% of each cash advance; \$5 minimum. Late fee: \$15 on balances up to \$100; \$29 on balances of \$100 up to \$250; \$39 on balances of \$250 and over Over-the-credit-line fee: \$35

22. This exception is likely authorized by Article I, Section 8 of the US Constitution, granting Congress the powers to regulate the armed forces and interstate commerce, both of which powers are interpreted very expansively.