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INTEREST RATE CEILINGS AND MICROFINANCE: THE STORY SO FAR

Introduction

The high interest rates charged by many microfinance institutions (MFIs) have attracted the attention of policy makers throughout the world. Several concerns have been raised: Why do institutions that set out to help the poor charge such high rates? How can governments support this practice from a political perspective? Should poor people have to pay for inefficiencies that result in high MFI costs? How can customers be best protected from predatory lenders, where they exist?

Historically, governments have used mandatory interest rate ceilings to address these kinds of concerns. Currently, about 40 developing and transitional countries have interest rate ceilings of some kind. Unfortunately, this often hurts rather than protects the most vulnerable by shrinking poor people's access to financial services. Interest rate ceilings make it difficult or impossible for formal and semi-formal microlenders to cover their costs, driving them out of the market (or keeping them from entering in the first place). Poor clients are either left with no access to financial services or must revert to informal credit markets (such as local moneylenders), which are even more expensive. Ceilings can also lead to less transparency about the costs of credit, as lenders cope with interest rate caps by adding confusing fees to their services.

Although interest rate ceilings do not have the desired effect, concerns about the high costs of microfinance and predatory lending practices remain valid. Competition, however, is the single most effective way to reduce both microcredit costs and interest rates. Policies to promote competition among credit providers, combined with relevant consumer protection measures like truth-in-lending laws, can go a long way toward expanding the reach of sustainable microcredit while safeguarding consumer interests.

This Occasional Paper aims to shed some light on the relationship between interest rate ceilings and microfinance. It presents the current state of knowledge, drawing on a review of the literature, anecdotal evidence provided by experts, and a CGAP survey of interest rate ceilings around the world. The paper outlines the rationale for high microcre-



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CGAP, the Consultative Group to Assist the Poor, is a consortium of 28 development agencies that supports microfinance. More information is available on the CGAP web site: www.cgap.org.



dit interest rates and the historical performance of subsidized lending schemes. It then examines the impact of interest rate ceilings on microfinance clients. The paper goes on to offer a typology of interest rate ceilings in developing and transitional countries, together with a description of the challenges inherent in implementing such ceilings. The paper concludes with policy recommendations on fostering lower microcredit interest rates through competition and consumer protection, without imposing interest rate ceilings.

Microcredit Interest Rates

To ensure that poor people have permanent access to the financial services they require, financial institutions must be able to cover their costs and make a profit that can be reinvested and fuel growth. Unless their costs are covered, financial institutions that serve poor clients will be dependent on ongoing subsidies, will likely operate only until the subsidies run out (i.e., for a limited time), and reach only a

small number of clients. Such institutions will also tend to be driven by donor or government goals, not client needs.

This section introduces the key dynamics of microcredit interest rates.¹ It addresses questions of cost structure and the affordability of cost-covering interest rates for poor people. It also reviews the reasons why subsidized schemes that offer artificially low interest rates have failed in the past.

Why Are Microcredit Interest Rates Higher than Bank Interest Rates?

Microcredit costs are high, but not because lending to poor clientele carries inherently higher risk. In fact, good microcredit programs often enjoy lower default rates than regular commercial banks. Microcredit costs are high because of the greater delivery costs of tiny transactions that require face-to-face interaction and because MFIs use personal contact as a substitute for formal collateral or computerized credit scoring. The costs of making a small loan will always be higher in percentage terms than the

Box 1 Microcredit Cost Structure

Compare the costs of two hypothetical lenders, Big Lender and MicroLender, each of which lends US \$1,000,000. Big Lender makes a single loan, while MicroLender makes 10,000 loans of US \$100 each.

The costs of capital and loan loss risk vary proportionally with loan size. Both lenders need to raise US \$1,000,000 to fund their loans and will have to pay the same market rate—say, 10 percent—for the money. If both lenders have a history of losing 1 percent of their loans to default each year, they will need a loan loss provision of that amount. Both lenders can cover the cost of their capital and their risk by charging 11 percent ($10\% + 1\% = 11\%$) on the loans they make to their customers.

Administrative costs are not proportional to loan size. Making a single loan of US \$1,000,000 might cost Big Lender US \$30,000 (3 percent of the loan amount) in staff time and other expenses involved in appraising, disbursing, monitoring, and collecting the loan. Big Lender can cover all its costs by charging the borrower an interest rate of 14 percent ($10\% + 1\% + 3\% = 14\%$).

However, MicroLender's administrative costs for each US \$100 loan will be much higher than 3 percent of the loan amount. Instead of US \$3 per borrower, MicroLender is more likely to have to spend US \$20 or more per borrower. Big Lender has to deal with only a single borrower, but MicroLender has to deal with 10,000 borrowers who typically do not have collateral, financial statements, or records in the database of a credit reporting bureau. Many of these clients may be illiterate. Lending to, and collecting from, such clients requires time-consuming personal interaction.

Assuming Big Lender's loan is repaid quarterly, it has to process four payment transactions per year. MicroLender's borrowers probably make repayments monthly or even more frequently, generating at least 120,000 transactions per year. While Big Lender's administrative cost is US \$30,000 per year, that of MicroLender is at least US \$200,000. Covering this cost requires a 20 percent charge on loaned amounts, resulting in an interest rate of at least 33 percent ($10\% + 1\% + 20\% = 33\%$). Note that administrative costs may be much higher in young MFIs that are too small to take advantage of economies of scale.

costs of a larger loan (see box 1). Three types of costs need to be covered by interest rates: the cost of funds for on-lending, the cost of risk (loan loss), and administrative costs (identifying and screening clients, processing loan applications, disbursing loans, collecting repayments, and following up on non-repayment).

Even though costs are usually proportionally higher for microcredit than for mainstream commercial bank lending, MFIs are often much more productive than commercial banks. For example, sustainable MFIs reporting to the Microfinance Information eXchange (MIX) handle, on average, 359 borrowers per loan officer.²

In another example, a sustainable Indian MFI incurs a cost of only US \$0.25 per customer interaction (i.e., per visit or per transaction). However, due to the high number of interactions, this low cost per transaction translates into 25 percent of operating costs relative to the average loan portfolio.³ In contrast, commercial banks in India typically have operating expenses in the range of 5–7 percent of outstanding loans.⁴ The challenge for microfinance is to stimulate innovations that improve productivity even further and reduce these administrative costs, thus permitting lower interest rates. But even at its most efficient, microlending will cost more than conventional lending.

How Can Poor People Afford Such High Interest Rates?

The poor generally consider ongoing access to credit more important than the actual cost of the credit.⁵ Impact studies show that clients benefit from microfinance loans. They also show that microfinance clients can and do repay such loans—in many cases, returning to borrow again.⁶ High repayment rates and repeat borrowing testify to the positive benefit that clients derive from microcredit. Further, high repayment indicates that the loans are affordable (if not, their inability to repay would show up in default rates).

Because the absolute amount is small, microcredit interest costs are generally affordable compared to the income streams and total business costs of poor clients, particularly those of non-agricultural microentrepreneurs. A study in the Dominican Republic, Colombia, and Chile, for example, found that even a 6 percent monthly interest rate represented only 0.4–3.4 percent of a microentrepreneur's total business costs.⁷ Returns on certain tiny businesses, especially commercial traders, are also higher per unit of capital than those on large businesses. Research in India, Kenya, and the Philippines found that the average annual return on investments in microenterprises ranged from 117 to 847 percent.⁸

The higher costs of microcredit have not necessarily excluded poor customers. Data from the MIX indicate that leading MFIs have succeeded in reaching large numbers of poor clients precisely because they have been allowed to charge interest rates that reflect their true costs, including the costs of growth. In 2004, the MIX analyzed MFIs reaching poor clients (defined as microlenders with an average balance per borrower of less than either 20 percent of GDP per capita or US \$150). MFIs serving this lower-end market with interest rates that covered their costs reached six times as many borrowers as their non-sustainable peers also serving that market.⁹

For most people, the alternatives to microcredit tend to be very expensive moneylenders, input suppliers, inflexible and risky local savings circles, or nothing at all. It is common for moneylenders to charge effective interest rates well in excess of 10 percent per month.¹⁰ A standard moneylender loan in the Philippines is the “5/6 loan”: for every five pesos borrowed in the morning, six must be repaid by evening. This amounts to a *daily* interest rate of 20 percent. Table 1 shows the interest rate options available in seven Asian countries in 2004.

In many countries, informal lenders are more likely to engage in predatory lending, defined as a pattern

Table 1 Annual Interest Rates of Commercial Banks, Moneylenders, and MFIs (approximately 2003)

Country	Commercial banks APR	MFIs APR	Informal sources (e.g., moneylenders) APR
Indonesia	18%	28–63% (BPRs, local-level microbanks)	120–720%
Cambodia	18%	~ 45%	120–180%
Nepal	11.5% (priority sectors) 15–18% (other)	18–24%	60–120%
India	12–15% (to SMEs)	20–40%	24–120% (depending on state)
Philippines	24–29%	60–80%	120+%
Bangladesh	10–13%	20–35%	180–240%

APR: Annual percentage rate

Source: Wright and Alamgir, *Microcredit Interest Rates in Bangladesh*, based on data prepared by Sanjay Sinha.

of behavior in which an unscrupulous lender exploits or dupes borrowers into assuming debt obligations that they may not be able to meet and uses abusive techniques to collect repayments. The costs of predatory lending can include loss of valuable collateral, transfer of wealth to lenders (especially over time), and/or social and psychological penalties.¹¹

What about Subsidized Interest Rate Lending Schemes?

To compensate for the reluctance of commercial lenders to enter specific market niches, such as rural or agricultural markets, governments have traditionally established specialized rural credit programs and institutions. These programs often hold interest rates at artificially low levels, which produces the same effect as an interest rate ceiling. Unfortunately, government- and donor-subsidized lending schemes that provide credit for poor people at unsustainably low interest rates have generally been unsuccessful in offering financial services over the long term to their target groups.

Since the 1970s, a growing body of literature has shown that subsidized interest rates are detrimental to the provision of financial services to the poor.¹²

Several problems are observed in subsidized lending programs. First, such programs are vulnerable to political patronage, can divert credit to better-off borrowers, and encourage rent-seeking behavior. Cheap funds lead to excess demand for loans, so that subsidized loans must be rationed, thereby exacerbating these adverse effects.

Subsidized lenders tend to favor larger borrowers, either because low interest rates do not allow them to cover the higher costs of smaller loans, or because larger borrowers hold more political clout. In 1991, an estimated 5 percent of African farms, and about 15 percent of farms in Asia and Latin America, had access to formal credit. Just 5 percent of borrowers received as much as 80 percent of this credit. Instead of narrowing income inequalities, low interest credit programs have often increased them.¹³

Second, borrowers often view soft government money as grants or gifts and are less likely to repay loans from subsidized programs. This is especially true in countries with a history of forgiveness programs for agricultural or other lending.¹⁴ Government-supported institutions also lack incentives to monitor such loans effectively, since success is defined more

Box 2 The Case of the Indian Integrated Rural Development Program (IRDP)

In the 1980s, the government of India introduced a variety of subsidized targeted lending programs, including the IRDP. The program suffered from all three classic problems of subsidized lending schemes: diversion of funding to the better-off, low repayment rates, and dependence on significant subsidies. The loan recovery rate on IDRPs varied between 10 and 55 percent; a 1993 study on rural finance reported widespread credit diversion and low levels of awareness of repayment conditions. By contrast, leading MFIs in India (Share and BASIX) enjoy nearly 100 percent repayment rates. The same study showed that the total costs to clients in the IRDP were between 26–38 percent when transaction costs (including bribes) were taken in account. Other studies have shown that IRDP tended to favor better-off segments of the rural population, rather than poorer groups.

Sources: Mahajan and Ramola, "Financial Services for the Rural Poor"; World Bank, "Microfinance in India"; and 2002 data from the MIX Market, www.mixmarket.org.

by lending volume than by financial performance. Default rates of 50 percent and higher in subsidized rural credit programs have been observed all over the world. Examples include India (50 percent), Bangladesh (71 percent), and Malaysia and Nepal (40 percent).¹⁵

Third, mandated low interest rates in government programs mean that lending institutions will never cover their costs and thus require continuous government or donor subsidies, a practice with significant fiscal implications. For example, the Banque Tunisienne de Solidarite (BTS) is a subsidized scheme with an annual interest rate of 5 percent per year, which is insufficient to cover costs.¹⁶ The bank consequently requires continuous government subsidies to survive.

The Impact of Interest Rate Ceilings on Poor Customers

Interest rate ceilings that are set too low for sustainable microfinance constrain poor people's access to financial services. The government entities that set interest rate caps (as well as the general public) do not

generally consider the cost structure of microfinance in their calculations. Rather, the reference point is nearly always the lower-cost commercial banking sector, which makes larger loans than the microfinance sector. This decision-making process means that in many cases governments find it politically difficult to set interest rate ceilings high enough for microfinance to flourish. While customers who manage to obtain loans governed by interest rate ceilings will benefit from lower interest rates, a much larger number of potential borrowers will be negatively affected.

This section examines two main effects of interest rate ceilings on poor people. One is limited access to credit, either through market contraction or the absence of microfinance lenders; and the other is reduced transparency regarding the total cost of loans.

Limited Access to Credit

When faced with an interest rate ceiling, MFIs will often retreat from the market, grow more slowly, and/or reduce their work in rural areas or other, more costly market segments because they cannot cover their operating costs. Similarly, interest ceilings discourage commercial banks from expanding into higher-cost rural or microcredit markets.

Evidence of a market contraction was seen in Nicaragua after the national parliament introduced an interest rate ceiling for specific types of lenders, including NGO-MFIs, in 2001. Annual portfolio growth of these MFIs fell from 30 percent to less than 2 percent. The imposition of interest rate ceilings also caused several microfinance institutions to leave rural areas, where risks and operational costs are higher.¹⁷

In West Africa, the regional central bank (Banque Centrale des Etats de l'Afrique de l'Ouest, or BCEAO) currently enforces an interest rate ceiling of 27 percent for non-bank lenders. This ceiling applies to microfinance institutions in most countries. As a result, several large MFIs are reported to be

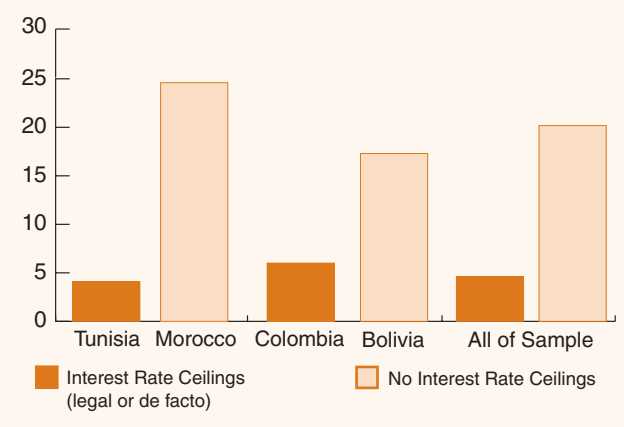
withdrawing from poorer, more remote communities and focusing instead on urban areas, which are less expensive to service. MFIs in West Africa are also increasing their average loan size—and presumably serving less poor clients—in an attempt to improve efficiency and returns. Yet these measures have not been successful. Of the 24 registered MFIs in Mali, 22 are not financially sustainable, partially due to the low rates of interest they must charge.¹⁸ The country’s banks, along with those in the rest of the region, face an even lower ceiling: 18 percent.

Recent research by ACCIÓN International asserts that interest rate ceilings in Colombia have repressed the development of commercial microfinance in that country, primarily by discouraging microfinance NGOs from transforming into licensed financial intermediaries.¹⁹ In Kenya, the threat of a new interest rate ceiling bill caused the Cooperative Bank of Kenya to put its plans for a major expansion into the microfinance market on hold.²⁰

It is difficult to substantiate arguments about what specific markets might have looked like without interest rate ceilings. However, a comparison of market penetration rates between 23 countries with interest rate ceilings and 7 countries without ceilings suggests higher penetration rates in the latter.²¹ On average, the former had a market penetration of 4.6 percent, whereas countries without interest rate ceilings, or ceilings that had little impact on microcredit, enjoyed penetration rates of 20.2 percent, more than four times higher (see figure 1).^{*} Market penetration figures for two pairs of countries with similar characteristics are also shown in figure 1, a comparison that sheds further light on the possible effects of interest rate ceilings.

Morocco and Bolivia clearly have significantly higher market penetration rates than their respective peers. One factor (among many) that differentiates the two pairs is the restrictive interest rate ceiling, whether legal or de facto, that exists in countries with

Figure 1 Microfinance Market Penetration in Countries with and without Interest Rate Ceilings, 2004



Note: Number of microfinance borrowers shown as percentage of population living on less than US \$2 per day.

Sources: Calculations for 23 countries with interest rate ceilings and 7 countries without ceilings based on Christen et al, *Financial Institutions with a “Double Bottom Line”*; and World Bank, *World Development Indicators, 2003*.

low penetration rates. It should be noted that structural problems related to large-scale state intervention in financial systems, not simply interest rate ceilings, have a significant impact on microfinance in many countries, including Tunisia.

Less Transparency

MFIs influenced by interest rate ceilings have tried to cover their costs by imposing new charges and fees.

^{*} The analysis in this paper uses a proxy indicator for market penetration among poor populations: the ratio of the number of microcredit loans to the number of persons estimated to be living on less than US \$2 per day. The source for the number of microcredit loans is Christen, Rosenberg, and Jayadeva, *Financial Institutions with a “Double Bottom Line,”* which discusses a CGAP survey of the global outreach of “alternative” financial institutions, including state-owned agricultural, development, and postal banks; member-owned savings and loan institutions; other savings banks; low-capital local and rural banks; and specialized microfinance institutions (MFIs) and programs of varying types (NGOs, non-bank financial institutions [NBFIs], and commercial banks). Calculations in the paper use data gathered on the total number of loan accounts per country. The methods of data collection and the limitations of this data set are explained in detail in the paper (p. 3-4). The estimates for the population living on less than US \$2 per day used in this paper come from World Bank, *World Development Indicators, 2003*.

Customers do not always clearly understand that these fees are part of the loan cost. Even when enforcement is weak, or when a de facto interest rate ceiling exists due to subsidized lending, financial institutions often try to give the impression of compliance by charging an interest rate in line with the ceiling, but then adding fees and commissions. This lack of transparency hurts the poor by undermining their ability to comparison shop for loans.

Laws themselves sometimes inadvertently invite this lack of transparency, since the definition of interest rate is not always clear, particularly in the case of usury laws. (See table 2 for definitions of some commonly misunderstood interest rate concepts.) Laws can be ambiguous about whether additional fees and commissions attached to loan products are included in the calculation of the loan interest rate. This is the case, for instance, in Armenia and Nicaragua. In addition, usury laws often do not include the total loan costs, whether on purpose or by omission.

Even in cases where there are clear rules for calculating the interest rate, and where the total cost of loans is included, authorities may find it difficult to design interest rate ceilings for other reasons. Microloans come in many different “shapes.” They vary widely by

term (1 month, 4 months, 6 months, 12 months) and repayment structure (daily, weekly, monthly, etc.). By altering just one of these variables, the effective interest rate on a loan product changes, creating an enormous variety of interest rates according to product. This makes it difficult to compare credit products on price alone and even harder to ensure transparency, regardless of whether interest rate ceilings exist.

In response to an interest rate ceiling, microfinance institutions in Nicaragua added a host of fees and charges to cover their costs. For instance, the microfinance program FDL added administrative fees that confused its clients.²² In South Africa, the Micro Finance Regulatory Council (MFRC), the body responsible for regulating microfinance in the country, was charged by the Department of Trade and Industry to coordinate a review of all consumer credit laws in the country in 2003. The Credit Law Review found that some institutions circumvented the caps by introducing credit life insurance and other charges, which reduced transparency on the full cost of credit.²³ Similarly, the Armenian law does not include a formula for how to calculate interest and fails to make clear whether other fees or charges should be factored into the interest rate for purposes of

Table 2 Interest Rates: Key Concepts and Definitions

Nominal interest rate	A nominal rate is the stated rate to be paid on a loan contract, usually stated as a monthly or annual percentage. It does not take into account related loan fees, commissions, and other expenses.
Effective interest rate	An effective rate converts all financial costs (e.g., interest, fees, and commissions) into a declining-balance interest calculation for the repayment period. The effective rate represents the financial cost to the borrower if no mandatory savings are required. It includes all financial charges as a percent of the loan amount used during each payment period.
Annual percentage rate (APR)	An APR is the effective interest per payment-period rate multiplied by the number of payment periods in a year.
Real interest rate	A real interest rate adjusts the interest rate to reflect the rate of inflation. A negative real rate implies that the rate of interest charged falls below the inflation rate. The term “positive rates of interest” is often used to mean that the rate is set above inflation.

determining compliance with the interest rate ceiling. As a result, both banks and MFIs have imposed various fees and charges.²⁴

Interest Rate Ceilings in Developing and Transitional Countries

Many developing countries liberalized interest rates during the 1980s in the context of financial sector reform. Nevertheless, a number of countries retained some sort of interest rate ceiling, and others have since introduced ceilings in an attempt to protect consumers from unscrupulous lending practices. Overall, most of the interest rate ceilings now in place are not oriented specifically toward microfinance, although they can have a significant impact on the sector if they are set below a rates that cover operational costs (also known as sustainable rates).

In some countries, the emergence of non-governmental MFIs charging interest rates higher than commercial and state banks has spurred governments to impose or consider imposing interest rate ceilings. Recent developments in Bolivia and Bangladesh are particularly relevant, as these two microfinance leaders have attained high levels of market penetration under liberalized interest rate regimes. A January 2004 presidential decree in Bolivia placed interest

rate ceilings on small loans. In Bangladesh, recent political debates prompted the major apex funding agency, PKSF, to impose lower on-lending rates on MFIs that borrow from it.

The increasing popularity of specialized microfinance laws in some countries could inadvertently result in future interest rate ceilings. In Morocco, for example, the 1999 Law on Microcredit Associations provides the Ministry of Finance with the right to set a maximum nominal interest rate—a right the Ministry has yet to exercise. In other countries, the interest rate issue appears to be re-emerging in policy dialogue. In Kenya, for example, the Donde Bill would apply interest rate ceilings across the board on many types of lenders.²⁵

Interest rate ceilings can take three basic forms: interest rate controls, usury rates, and de facto ceilings (see box 3). As shown in table 3, CGAP identified nearly 40 countries with some sort of interest rate ceiling in 2004. Eleven had interest rate controls: Algeria, the Bahamas, China, Libya, Morocco, Myanmar, Paraguay, Syria, Tunisia, UEAC, and UMOA. These ceilings are generally associated with pervasive control by the state over the entire financial system and are usually well enforced.

Several countries had some sort of usury law, including the countries covered by the UMOA (Union

Box 3 Typology of Interest Rate Ceilings

Banking interest rate controls. These controls are generally codified into banking and central bank laws, which grant the central bank of a country the legal authority to fix the maximum lending interest rate (and sometimes the minimum interest rate for deposits) for regulated financial institutions. As a result of financial sector liberalization, these types of controls have been largely abandoned in monetary policy, but remain in force in a few countries.

Usury limits. Usury laws are usually part of a civil code (or its counterpart in common law legal systems) and authorize a government body, generally the central bank, to set a limit that private lenders may charge. In some cases, financial institutions falling under the banking law and regulated by the central bank are not subject to the usury limit, which is aimed primarily at private and consumer lending. NGO MFIs are often affected by these laws.

De facto ceilings. In some countries, formal interest rate ceilings are not codified into law, but political pressure and/or the need to compete with large subsidized government lending programs keeps interest rates below a specific level. Some countries have both banking rate controls (or usury limits) and large subsidized government programs.

Monétaire Ouest Africaine, or West African Monetary Union) and UEAC (Union des Etats d’Afrique Centrale, or Union of Central African States).²⁶

The impact of interest rate ceilings, especially usury laws, depends on two main factors. The first is the level of the interest rate ceiling itself. Low ceilings are presumed to have a high impact on microfinance because they are too low to allow for cost recovery,

especially in more remote or more costly market segments. In some cases (e.g., Colombia and Armenia), the usury limit is high enough not to affect traditional bank operations and some urban microfinance. But such limits can nevertheless affect microfinance operations of financial institutions that are subject to the law, particularly in remote or rural areas.²⁷

The second factor is the level of enforcement of the ceiling. Enforcement varies according to local conditions, including the clarity of the law or regulation and the incentives and institutional capacity of the agency charged with enforcement. In Colombia and some West African countries such as Mali, interest rate ceilings are reported to be strictly enforced.²⁸

However, interest rate ceilings are often difficult to enforce, particularly when it comes to microfinance. The laws establishing them, especially usury laws, are often proposed by politicians and not by agencies or other groups with expertise in finance. The responsibility for enforcement is not always clear or is placed with bodies without adequate technical expertise. Since the laws often apply to large numbers of non-bank institutions or even individuals, these authorities simply do not have the enforcement capacity required—the case of Armenia, South Africa, and several countries in Latin America.

In countries with de facto interest rate ceilings, large state-owned banks offer large volumes of credit at subsidized rates, resulting in heavy annual losses that must continually be funded from the treasury. Examples of

Table 3 Interest Rate Ceilings in Developing and Transition Countries, 2004

Interest rate controls	Usury limits	De facto controls
Algeria	Armenia	Brazil
Bahamas	Bolivia ^d	China
China	Brazil ^a	Ethiopia
Libya	Chile	India
Morocco ^a	Colombia ^b	Laos
Myanmar	Ecuador ^b	Pakistan
Paraguay	Guatemala	Vietnam
Syria	Honduras ^a	
Tunisia ^a	Indian States	
UEAC ^b	Nicaragua ^c	
UMOA ^a	South Africa ^b	
	Uruguay	
	Venezuela ^c	

Notes:

- ^d A separate regulation on interest rate ceilings exists for the microfinance sector.
- ^b Microfinance lenders are excluded from interest rate ceilings, or are authorized to charge additional fees.
- ^c Interest rate ceilings apply only to institutions and individuals not regulated by banking authorities (including NGOs).
- ^d Introduced in January 2004.

Box 4 Challenges to Enforcing Interest Rate Ceilings in Benin

In the UMOA, the Ministry of Finance in Benin (and, indeed, in most participating UMOA countries) has been unable to effectively supervise all licensed and registered MFIs in the country due to a lack of capacity, both human and technical. Since the creation of the special microfinance unit (Cellule Microfinance) at the Benin Ministry of Finance, only 14 MFIs have had an on-site inspection. Under the law, all MFIs are required to submit their annual financial statements, but in 2000, only 35 statements were received, representing a compliance rate of approximately 41 percent. No sanctions were levied against non-compliant licensed MFIs. To put the supervision workload into perspective, the regional Banking Commission for the entire UMOA region supervises a total of 59 commercial banks, while the *Cellule Microfinance* in Benin monitors 83 licensed MFIs.

Source: Ouattara, *Microfinance Regulation in Benin*.

Box 5 Brazil: A Case of De facto Interest Rate Ceilings

Launched in July 2003, Brazil's "Programa de Credito Popular (PPCP)" promised R\$1 billion (US \$1.7 billion) in low-cost funding for organizations engaged in microcredit. Only federal banks can access the funds directly. All other institutions are required to borrow the funds from the Brazilian Development Bank (BNDES). BNDES requires MFIs to on-lend these funds at a maximum of 2 percent per month. Brazilian MFIs argue that the low rate does not allow them to cover their costs. The resulting impasse between BNDES and the MFIs has frozen microfinance activity in Brazil at 2002 levels; BNDES has yet to disburse any of the funds. "There is no demand for an unacceptable product," said Jose Caetano Lavorta Alves, president of ABCred, an association of Brazilian microfinance organizations. Thanks primarily to pressure from ABCred and the largest MFIs, the government is revisiting the program's interest rate ceiling.

Sources: Bueno and Carvalho, *Governo vai reativar*; Neumann and Carvalho, *Microcredito busca novos caminhos*.

this practice, sometimes called "policy lending," can be seen in China, Laos, and Vietnam. The effect of these schemes is to make it impossible for other players to compete if they charge sustainable interest rates.

The Asian Development Bank reports that a long history of government-subsidized credit programs in Vietnam has led borrowers to expect subsidized loans forever. Even though interest rate ceilings were officially lifted in June 2002, in practice, state-owned banks (which represent 70 percent of total Vietnamese banking system assets) still follow directions from the Central Bank or other ministries. The Vietnam Bank for Social Policy (which caps lending rates at 6 percent per year) and the Vietnam Bank for Agriculture and Rural Development continue to crowd out competition, inhibiting the deepening of the financial sector.²⁹

In other countries, such as Ethiopia and Ghana, significant political pressure exists to keep interest rates artificially low, even without an official ceiling. In 1998, the National Bank of Ethiopia removed all interest rate ceilings in the financial sector, but the majority of microfinance institutions have chosen to maintain a lower rate of interest, mainly for political reasons. The ownership of Ethiopian MFIs rests with regional governments, local NGOs, and individuals. The sector is highly concentrated, with two large MFIs accounting for 90 percent of savings, nearly 76 percent of the outstanding microcredit portfolio, and 83 percent of total microfinance clientele. As a result,

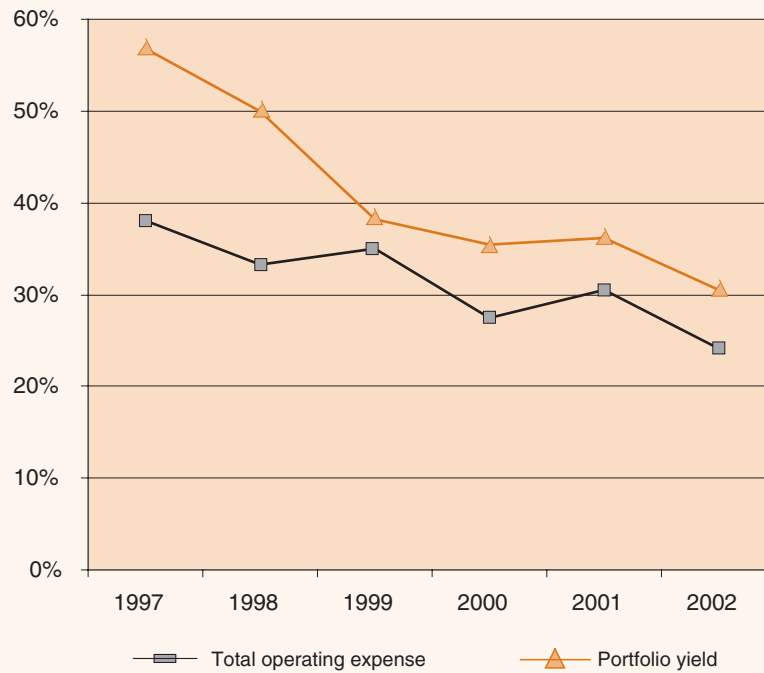
many Ethiopian MFIs are not financially sustainable and are unlikely to achieve growth and massive outreach without continual subsidies.³⁰ In Pakistan, interest rates are similarly repressed, both unofficially and through subsidization of government lending programs. In the agricultural policy announced by the government in June 2004, Zarai Taraqati Bank, Ltd., (ZTBL, formerly the Agricultural Development Bank of Pakistan) interest rates for agricultural lending were capped at 9.5 percent on an annual basis and other concessions were announced for borrowers with arrears on ZTBL loans.³¹

Policy Implications and Options

Interest rate ceilings do not necessarily protect poor customers and can, in fact, hurt them by reducing their access to financial services. Even if ceilings could bring down microcredit interest rates, they are difficult to enforce properly. These facts do not, however, minimize the critical need to bring down the costs of microcredit and develop innovations to reach poorer and more remote clients sustainably.

At the same time, predatory lending and consumer abuses are legitimate policy concerns, both in developed and developing countries. What should governments do? This section outlines recommendations for tackling the issues of cost and consumer protection. It argues that the most important role for governments is to

Figure 2 Decreasing Portfolio Yields in Four Countries, 1997–2002 (percentages)



Source: MIX, 2004, unpublished research.

Notes: The figure uses unweighted average totals for Bolivia, Bosnia, Cambodia, and Nicaragua. Total operating expense includes all administrative and interest rate expenses.

expand the reach of the financial sector by fostering innovation, competition, and transparency through appropriate legal and regulatory frameworks and consumer protection policies.

Competition and Improved Efficiency: Making Markets Work

The most powerful mechanism for lowering interest rates in microfinance is competition. In many competitive markets, efficiency has improved and microcredit interest rates have declined. As shown in figure 2, for instance, the microfinance portfolio yield decreased from an average of 57 percent in 1997 to 31 percent in 2002 in four competitive markets not affected by interest rate caps: Bolivia, Bosnia, Cambodia, and Nicaragua. Operating efficiency (total administrative, or non-financial, costs as a percentage of the average loan portfolio) improved over the same period from 38 to 24 percent.

This downward trend was driven primarily by efficiency improvements spurred by competition.³²

In Bolivia, market pioneer BancoSol charged a combination of interest and fees equivalent to a 65 percent annual percentage rate when it began operating as a bank in 1992. Today, BancoSol operates in a highly competitive environment, has brought down its costs, and charges an annual percentage rate of 22 percent.³³ In Cambodia, a relatively new but competitive microfinance market, interest rates have dropped from around 5 percent to 3.5 percent per month over the past few years. In some provinces where MFIs are particularly active, informal moneylenders have lowered their rates to match those of MFIs.³⁴

The microfinance industry has emphasized market interest rates as a way to improve sustainability. Less attention has been placed on spurring competition and boosting the capacity of financial institutions to

respond to competition (e.g., via efficiency improvements and lower interest rates). Going forward, governments, microfinance associations and networks, and international donors should stimulate competition among a wide array of financial institutions and promote innovation aimed at reducing microcredit operating costs.

First and foremost, a stable macroeconomic situation is a critical precondition for competitive microfinance. Also important is an appropriate legal and regulatory framework that provides a “level playing field,” allowing for market entry and a reasonable operating environment for diverse types of financial institutions.³⁵ Investments in basic telecommunications, roads, and education are also critical for future efficiency improvements in microfinance. In addition, given the strong role still played by international donors in microfinance, development assistance should focus on promoting innovations, especially the streamlining and improvement of business processes and the application of technology to reduce costs. Donors can also work directly with financial institutions, as well as other actors that make up the financial architecture of a given country (e.g., credit bureaus, rating agencies, auditors, etc.), to increase the flow and quality of transparent information about performance, prices, and customers.

Consumer Protection

High-risk groups deserve protection from predatory lending and unscrupulous business practices. Such practices include lending without regard for a borrower’s ability to repay, deceptive pricing, and abusive collection techniques. These practices probably hurt borrowers more than high interest rates do.

Adequate consumer protection laws can provide a safeguard against abuses without the negative effects of interest rate ceilings. Consumer protection laws define and prohibit “abusive” lending and collection practices, require mandatory disclosure on total loan

costs, specify clearly defined complaint resolution procedures, mandate consumer education to prevent abuse, and establish effective enforcement mechanisms. Such laws are already in place in the financial industry of developed countries, such as the United States, Canada, and the member states of the European Union. South Africa and some South American countries (such as Peru, Bolivia, and Colombia) also have consumer protection laws.

Most existing consumer protection laws in the financial sector require transparent disclosure of interest rates and all other loan costs, using standardized mathematical formulas applicable to all types of lenders. Truth-in-lending laws, for example, typically require lenders to disclose to borrowers the true cost of a loan as an effective interest rate,³⁶ as well as to explain other key loan terms in all loan documents and other publicly accessible materials, such as advertising.

- In the European Union, a consumer credit-protection directive sets minimum truth-in-lending standards for EU member states. Among other things, the directive stipulates that all credit agreements must include the total cost of a loan, expressed as an effective interest rate, and that all creditors must use a single formula to determine this rate.** The European Commission and European Parliament are currently discussing even more stringent consumer protection measures.³⁷

The EU directive will likely affect microfinance in both new member states (e.g., Poland) and candidate countries (e.g., Romania and Bulgaria). In addition, many other countries, including Croatia and Armenia, have signed treaties in which they committed to harmonize their economic laws with EU standards.

**Although the effective interest rate is referred to as the annual percentage rate (APR) in European legislation on loan cost disclosure, this term corresponds to the definition of effective interest rate used in this paper. In the United States, APR is defined less stringently: the effective periodic rate is annualized by multiplication rather than compounding.

- In the United States, lenders are required to display a “Schumer Box” (named after the senator who led the passage of the bill through Congress). This box draws together all the key disclosures spread throughout the small print of a credit agreement into one highlighted place.³⁸
- In South Africa, the MFRC requires institutions that qualify for an exemption from the applicable interest rate ceiling to use a standard one-page loan agreement for all loans.³⁹
- In member countries of the Union of Central African States, the 2002 microfinance law requires MFIs to disclose the effective interest rate in loan contracts and to post it on their premises. A clear and precise formula for calculating the effective rate is determined by the Central Bank governor, published by decree. Bank supervisors have already fined several MFIs for breaching this truth-in-lending provision.⁴⁰
- In Panama, the Superintendency of Banks issued a resolution in 2000 that obligates banks to provide their customers with information on the effective interest rate and the nature of a loan product, along with other disclosure information.⁴¹

Truth-in-lending requirements help ameliorate concerns about consumer abuse. Some policy makers in Eastern Europe and the Middle East have been dissuaded (at least temporarily) from implementing interest rate ceilings by the argument that transparent loan cost disclosure may be a better solution.⁴² In theory, fair, comparable, and widely available information on true loan costs allows borrowers to comparison shop for loans. It also stimulates competition among lenders and compels them to become more efficient to stay in business. Savings gained from more efficient practices can then be passed on to customers in the form of lower interest rates.

Truth-in-lending laws may not be as useful in certain contexts. For example, such laws may generate fewer benefits in countries where there is little competition among lenders that serve the poor.

Borrowers in such countries usually do not have a choice among equivalent loan providers, so information allowing them to compare costs is somewhat less relevant. Alternatively, early disclosure rules in a young microfinance market could discourage banks from entering the market and penalize start-up operations with high initial interest rates.

In some countries where microcredit is not yet established and people do not understand the need for higher interest rates on tiny loans, full disclosure of high-priced microcredit loans to the poor might cause a political backlash, especially if microfinance loans are compared to cheaper loans made by commercial banks to wealthier clients.⁴³ Finally, lack of consumer understanding of APR concepts and the difficulty of enforcing required interest rate calculations tend to limit the effectiveness of loan cost disclosure, both as a consumer protection tool and as a means of spurring efficiency improvements that can lead to lower-priced microcredit.

Consumer Education and Financial Literacy

While consumer protection laws focus on ensuring that lenders behave responsibly and ethically, consumer education and financial literacy programs aim to educate consumers on how to be more responsible borrowers. Financial literacy refers to the knowledge, skills, and attitudes required to adopt good money management practices for earning, spending, saving, borrowing, and investing. Participants in financial literacy programs are equipped with the information and tools to make better financial choices, work towards their financial goals, and improve their economic well-being.⁴⁴

For poor people, good money management is a daily challenge. Pressures on their cash flow are persistent and often urgent. Financial education has a role in building the capacity of the poor to gain control, become proactive, and use information and resources to enhance their economic security.⁴⁵

The seriousness of the problem of borrowers without basic financial literacy has come to the forefront recently, especially in industrialized countries. In the United States, for example, around 22 million households (about 56 million people, or 20 percent of the population) do not have bank accounts, despite easy rules for opening such accounts. At the same time, disadvantaged groups, such as low-income neighborhoods and minorities, make heavy use of a variety of non-bank financial service companies that charge high fees, including payday lenders, check-cashing services, tax preparation companies, and companies that send money from immigrants to their families abroad. These financial service companies collect US \$8 billion in fees annually for services that most banks provide free to account holders.⁴⁶

In the United Kingdom, research indicates that 39 percent of borrowers read only the main information on the front page of a credit agreement before signing and are often unaware of any clauses that may be to their detriment. In addition, over three-quarters of credit card holders do not know which APR applies to their card, despite being aware that the APR is the key piece of comparative cost information.⁴⁷ In India, a study of rural financial institutions found that of 600 rural poor individuals who had taken a loan, 92 percent did not know the interest rate, 28 percent did not know the repayment amount, and 29 percent did not know the balance outstanding.⁴⁸

To address this problem, government and private voluntary groups are working to educate low-income consumers on their financial options in both the United States and the United Kingdom. The goal of consumer protection activists in the United States has shifted from advocating ceilings on interest rates to a focus on consumer education and consumer protection laws against predatory lending. International banks are also investing heavily on education worldwide. For instance, Citigroup plans to spend US \$200 million over the next ten years on financial literacy in 100 countries.⁴⁹

In South Africa, the MFRC runs a consumer education campaign in five local languages, with mixed success. However, the MFRC has found consumer education to be a long-term investment. The consumer complaint hotline of the regulatory body has been more immediately effective as a consumer protection mechanism. In 2003, the MFRC received 339 complaints, resulting in the deregistration of five lenders and approximately US \$40,000 in fines. Through this mechanism, the MFRC has found that abusive practices and misleading information on repayments have generally been more problematic than high interest rates.⁵⁰

The United Kingdom intends to make it easier for consumers to challenge unfair agreements and seek redress through an accessible Alternate Dispute Resolution (ADR). Court action is perceived as being costly, complex, intimidating, and lengthy. The introduction of an ADR system should make it easier to resolve disputes in a speedy, fair, and inexpensive manner, benefiting both lenders and consumers.⁵¹

Conclusion

This paper argues that interest rate ceilings, found in nearly 40 developing and transitional countries, can hurt poor people. These 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 borrower's true cost. Reduced transparency occurs because lenders create confusing terms and charges in order to camouflage the actual interest rate.

At the same time, poor borrowers should not have to pay for inefficient lending. The best way for governments and donors to lower interest rates without making microcredit unsustainable is to promote competition and innovation, both of which improve efficiency and lower prices.

Abusive lending practices such as lending without prudent regard for repayment capacity, deceptive terms, and unacceptable collection techniques probably cause more damage to poor borrowers than do high interest rates. Consumer education can make the poor smarter consumers of financial services by

giving them the skills necessary to make informed financial choices. Instead of limiting interest rates, governments and the donors who support them may be better off addressing these abuses through a combination of consumer education and consumer protection legislation.

Box 6 Agenda for Future Research

Research is needed to strengthen empirical evidence about the impact of interest rate ceilings on microcredit clients and to analyze effective alternatives for protecting their interests. Promising topics include:

- country-level research comparing the situation “before” and “after” interest rate ceilings are imposed (e.g., Nicaragua and Colombia)
- comparisons of microfinance market penetration in countries with and without interest rate ceilings
- analysis of the profile of microcredit clients who can afford high interest rates—and those who might be excluded or harmed by such rates
- further research on how competition affects interest rates, as well as how competition can be best supported by governments and donors
- studies of successful cases of reducing the operating costs of MFIs: what are the principle techniques?
- the effectiveness of consumer protection measures in promoting consumer choice and spurring competition, especially the impact of total loan cost disclosure



Endnotes

- 1 Extensive literature exists on the level of and rationale for microcredit interest rates. This section merely summarizes points relevant to the discussion of interest rate ceilings. For more on this topic, see Rosenberg, *Microcredit Interest Rates*; Goodwin-Groen, *Making Sense of Microcredit Interest Rates*; and Donaghue, *Interest Rates in Microfinance*.
- 2 The MIX is a global information service that is helping to build the market infrastructure for the microfinance industry. See www.themix.org.
- 3 Interview with Ramesh Bellamkonda of Bharatha Swamukti Samsthe, April 2004.
- 4 Interview with Vijay Mahajan, BASIX, July 2004.
- 5 For an overview of microfinance and a discussion of the importance of access relative to price, see Christen et al, *Maximizing the Outreach of Microenterprise Finance*; and Robinson, *Sustainable Finance for the Poor*.
- 6 For an overview of recent impact studies, see Littlefield, Mor-duch, and Hashemi, *Is Microfinance an Effective Strategy?*
- 7 Castello, Stearns, and Christen, *Exposing Interest Rates*, 12ff.
- 8 Harper, *Profit for the Poor*, 15; and Hossain and Diaz, *Reaching the Poor*, 25.
- 9 Stephens, *Depth of Outreach*, 2.
- 10 For more information on moneylenders and their lending rates, see Robinson, *Sustainable Finance for the Poor*, 177–213.
- 11 Honohan, “Financial Sector Policy,” 26.
- 12 See, for example, Shaw, *Financial Deepening*, chapter 4; McKinnon, *Money and Capital*, 14–16, and chapter 7; Adams, Graham, and Von Pischke, *Undermining Development With Cheap Credit*; and World Bank, *Limitations of Cheap Credit*.
- 13 Braverman and Huppi, “Improving Rural Finance.”

Endnotes *continued*

- 14 Brandsma and Hart, *Making Microfinance Work Better*, 36.
 - 15 Braverman and Huppi, "Improving Rural Finance."
 - 16 Interview with Michael Cracknell, Enda Tunisia, May 2004.
 - 17 Interview with Alfredo Alaniz, president of the Association of Nicaraguan Microfinance Institutions (ASOMIF), October 2003.
 - 18 Interview with Christian Loupeda, Freedom from Hunger, May 2004.
 - 19 Trigo Loubière, Devaney, and Rhyne, *Lessons on Microfinance Regulation*, 7–8.
 - 20 Wright and Alamgir, "Microcredit Interest Rates in Bangladesh," 17.
 - 21 The countries with interest rate ceilings are Armenia, Brazil, Burkina Faso, Cameroon, Central African Republic, Chile, China, Colombia, Côte d'Ivoire, Ecuador, Ethiopia, Guatemala, Honduras, Laos, Mali, Nicaragua, Niger, Paraguay, Senegal, South Africa, Tunisia, Venezuela, and Vietnam. The countries without interest rate ceilings are Bangladesh, Bolivia, Egypt, Indonesia, Morocco, Peru, and Sri Lanka. Availability of data and the status of interest rate ceilings affected the selection of countries for the comparison sample.
 - 22 Interview with Julio Flores, executive director, FDL, December 2003.
 - 23 South Africa Department of Trade and Industry, "Summary of Findings."
 - 24 Interview with Monika Harutyunyan, Armenia Microenterprise Development Initiative, April 2004.
 - 25 Wright and Alamgir, "Microcredit Interest Rates in Bangladesh," 17.
 - 26 UMOA consists of Benin, Burkina Faso, Guinea Conakry, Guinea Bissau, Côte d'Ivoire, Niger, Mali, Senegal, and Togo. The central bank of this union is the BCEAO (Banque Centrale des Etats de l'Afrique de l'Ouest). UEAC consists of Chad, Cameroon, Central African Republic, Gabon, the Republic of Congo, and Equatorial Guinea. The central bank of this union is BEAC (Banque des Etats de l'Afrique Centrale).
 - 27 Interview with Ernesto Aguirre, former superintendent of banks, Colombia.
 - 28 Interview with Christian Loupeda, Freedom From Hunger, May 2004.
 - 29 Interview with Brett Coleman, ADB microfinance specialist, March 2004.
 - 30 Shiferaw and Ahma, *Revisiting the Regulatory and Supervision Framework*; Hardy, Holden, and Propkopenko, *Microfinance Institutions and Public Policy*.
 - 31 Interview with Steve Rasmussen, Pakistan Microfinance Network, July 2004.
 - 32 MIX, 2004, unpublished research. MIX data was used for countries for which time series data existed. An unweighted average of country averages for operating efficiency was used for each year. Even though Nicaragua introduced a usury rate in 2001, all of the cost savings and most of the interest rate reduction resulting from competition had already taken place.
 - 33 Interview with Julio C. Herbas Gutierrez, manager, Banco Solidario, S.A., April 2004.
 - 34 Interview with Mathieu Cognac, GRET, November 2003.
 - 35 For more information on these policy issues, see Christen, Lyman, and Rosenberg, *Guiding Principles of Regulation and Supervision*; and Duflos and Imboden, *The Role of Governments in Microfinance*.
 - 36 See box 2 for definitions of different types of interest rates.
 - 37 Robie, 2004, "EU Consumer Protection Laws."
 - 38 See the US Truth in Lending Act (TILA), passed in 1968, 15 U.S.C. 1600 et. seq.
 - 39 MFRC, 2004, internal discussion paper.
 - 40 Interview with Henry Madrenes, technical assistant to BEAC, April 2004.
 - 41 Superintendencia de Bancos, Republica de Panama, General Resolution N° 3-2000.
 - 42 Interview with Timothy Lyman, microfinance policy expert, May 2004.
 - 43 An exception might be in hyperinflationary countries, where consumers are used to high rates of everything, including interest.
 - 44 Cohen, Stack, and McGuinness, "Financial Education: A Win-Win."
 - 45 Sebstad and Cohen, "Financial Education for the Poor," 6.
 - 46 Anft, "A New Way to Curb Poverty," 7.
 - 47 UK Office of Fair Trading, *Credit Card Survey*.
 - 48 Mahajan and Ramola, "Financial Services for the Rural Poor," 4, box 2.
 - 49 Citigroup, "Citigroup Announces US \$200 Million Global Commitment."
 - 50 Interview with Gabriel Davel, Director, MFRC, April 2004. See also MFRC Call Centre Annual Statistics, www.mfrc.co.za (accessed 7 June 2004).
 - 51 UK Department of Fair Trade and Industry, "Fair, Clear, and Competitive," 54.
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