



# Fair interest rates when lending to the poor

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## 1. INTRODUCTION

Debates on fair prices have a long history, starting with Aristotle's denunciation of interest as the unnatural fruit of a barren parent. More recently, the fair trade movement has started to lobby for a fair remuneration of workers in low-income countries.

Microcredits have been developed to offer fairer prices for borrowing capital to small entrepreneurs in developing countries. Today, many poor citizens in developing countries can only access credit through informal lenders. Two and a half billion people lack access to financial services. When they have access to microcredits, they receive loans at a lower price than with these informal lenders. With the Grameen Bank and M. Yunus, the jury for the Nobel Peace Prize recently rewarded efforts by microfinance institutions (MFIs) "to create economic and social development from below".

Nevertheless, and except for a few countries where the microfinance market is very competitive, microfinance institutions still charge very high interest rates, partly due to the high transaction and operating costs of small loans. These rates often range from 20% to 60% per year, according to environmental factors or the loan's methodology. Compartamos, one of the fastest growing sustainable MFIs in Latin America, is even charging an annual rate of 120% after fees and taxation have been accounted for (New Yorker, 2006).

While high interest rates are still sometimes discussed and challenged inside the microfinance sector, the new and growing ethical inflection is currently coming from outside, i.e. from civil society or politics. During the summer of 2006, around fifty branches of two major MFIs were closed by district authorities in Andhra Pradesh State, India (Fouillet, 2006). The authorities denounced what they considered usurious interest rates with forced or unethical recovery practices. Ethical issues and particularly debates on interest rate levels are thus now widely accepted as a major threat to the social acceptability of the microfinance sector.

This article will propose four approaches to determining fair interest rates in microfinance and will identify the potential trade-offs and pitfalls associated with each approach.

## **2. INTEREST RATES IN MICROFINANCE**

It is generally very difficult to compare interest rate levels. The social and economic environment of lenders, customs, taxes, currencies, or laws can easily differ (Homer and Sylla 2005). Nevertheless, as Homer and Sylla (2005, p. 9) also argue, “we should not refuse to compare effects because causes have changed”.

The debate on the importance of interest rates has long been contested in the ethics and economics literature. Economists with an egalitarian leaning have argued that interest rate levels matter since they represent a major source of inequality in the distribution of income. The traditional response to their argument has been that even if they are very unequally distributed relative to wealth, interest payments have a fairly moderate effect on the inequality of income because of their low absolute share of household expenditures. The effect of the unequal distribution thus becomes unimportant (see Conard 1959, pp. 99-101).

The very concept of diminishing marginal return to capital suggests that enterprises with little capital should be able to earn a higher return on their investments than larger, better capitalized enterprises. The poorest entrepreneurs should thus be able to afford to pay higher interests, and money would then flow from rich depositors to poor lenders (see Armendariz de Aghion and Morduch 2005). The Nobel laureate in economics Robert Lucas has calculated the difference in return based on the marginal return of capital and found that under classical assumptions, the poor Indian borrowers should be willing to pay fifty to eighty times as much for capital as borrowers in the United States (Lucas 1990, pp.92-96).

In poor areas, the ratio of interest rate payments to overall costs is certainly still small for many poor entrepreneurs active in very productive sectors, even if it may not be dismissed as negligible. As argued by many donors or microfinance institutions, interest rate levels should not be problematic because the high turnover of the activities of poor clients enables them to pay high interest rates (see Helms and Reille, 2004).

Even at the bottom of the income pyramid, very poor borrowers active in petty trade or selling goods in small markets in developing countries repay rapidly thanks to the very high margins and turnover of their income-generating activity. In short, the borrowers targeted by microfinance activities should not be responsive to price changes below very high levels of interest rates. There is however very little data on the returns on investment of the poor, and the importance of interest rate payments for them.

The survey by Castello *et al.*, which is based on the detailed study of nine micro-entrepreneurs and one of the most quoted studies, is an exception. Very few studies exist on the influence of interest rates on revenues. A case study of Moroccan micro-entrepreneurs suggests that for some activities, such as the farmers, interest rates can represent up to 45% of total benefits of the business (PlaNet Finance, 2006). Another survey found that interest rates charged by the institution are one of the two main selection criteria of borrowers (Wright and Rippey, 2003). In line with Dehejia *et al.* (2005), one could thus assume that the poorest clients such as farmers are more sensitive to interest rate levels. High interest rates charged to poor borrowers usually do not reflect the lack of creditworthiness of the clients or

an excess demand for funds. In many cases, they are due to the lack of competition in the credit market or a monopolistic situation.

### **3. FOUR APPROACHES TO DETERMINE FAIR INTEREST RATES**

Before the 70s, interest rates charged to poor entrepreneurs in development projects, particularly rural ones, were very low. In the 70s and 80s, these low interest rates policies became controversial, especially in response to the emergence of very costly microcredit loans. For example, the seminal book *Undermining rural development with cheap credit* by Adams *et al.* (1984) or other papers from Ohio School scholars were a response to the view that the rural poor should pay low and highly subsidized interest rates. Cheap credit would destroy the incentives to save and distort the way lenders allocate funds (Adams *et al.*, 1984, p. 75). The rationale was that “low interest rates on loans to rural people end, paradoxically, by restricting their access to financial services” (Von Pischke, 1983, p. 176).

Four main approaches and criteria of fairness of interest rates can be identified. The first refers to deontological arguments. The second approaches the question through the marginal impact on the client’s financial situation. The third is market-based and focuses on the demand for credit. The fourth and last one suggests a procedural definition of fair interest rates based on the fair wage literature.

The deontological approach, the **first** and oldest one, has a long history. Aristotle already denounced interest as the unnatural fruit of a barren parent (see Conard 1959, p. 97). Similarly, heated theological debates on the legality of interest have flourished for centuries. The Council of Nice condemned interest in 325 AD, on the basis of the Old Testament’s prohibition of the charging of interest among fellow Jews. Usury laws, prohibiting interest rates or limiting their maximum level, have historically flourished based on these kinds of religious beliefs. Additionally, some of the proponents of usury laws root their arguments in the defense of the borrower in terms of the Marxist notion of exploitation or “super-exploitation”, when the borrower has to pay a surplus-value<sup>1</sup>. Similarly, Keynes (1936, pp. 378-379) hoped that pure interest rates could be driven to zero within one generation, to do away with the *rentiers*. In religious, Marxist, and Keynesian understanding, high interest rates are looked upon as either intrinsically unjust or potentially harmful. Usury laws, often based on a combination of these understandings, are designed as a tool to constrain lenders’ activities and protect the clients against potentially extortive interest rates. Usury laws are widely used in developed and developing countries. Helms and Reille (2004) recently listed about forty developing and transitional countries that have introduced regulations about interest rate ceilings of some kind.

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<sup>1</sup> In Chapter 27 of Volume 3 of the *Capital*, Marx (1894) explains that: “The two characteristics immanent in the credit system are, on the one hand, to develop the incentive of capitalist production, enrichment through exploitation of the labour of others, (...); on the other hand, to constitute the form of transition to a new mode of production”.

Nevertheless, some proponents of the new microfinance schemes have constantly challenged the effectiveness of those laws. Gonzalez-Vega (1977) argued already thirty years ago that any limitation on the interest rate level would have counter-productive effects. Low interest rates or usury laws would make the institutions concentrate their portfolio on fewer clients, the most profitable and powerful ones. Concretely, a usury law putting a low interest rate as maximum would force managers of institutions with limited resources or insufficient margins to issue larger loans in order to decrease their operating costs, and therefore would exclude the poorest segment from their portfolio. Furthermore, according to Adams *et al.* (1984), higher and more flexible interest rates would result in a more equitable income distribution.

The **second** approach, consequentialist in nature, addresses the fairness issue by assessing the amelioration or worsening of the client's situation. To assess the fairness of interest rates, one should evaluate the client's costs in the absence of the lending institution. In microfinance, this refers to the fact that, even if microcredit interest rates are high, they are much lower than interest rates that the microentrepreneurs previously borrowed at. The interest rate is deemed to be fair since all previous and second best opportunities are much more expensive<sup>2</sup>. For instance, Aleem (1990) reports an interest differential between formal and informal lenders of more than 50 percentage points.

Two critiques can be offered. First, accepting the informal lenders' interest rates as point of comparison legitimates a financial system whose practices of exclusion are undeniably unjust by almost all theories of justice.

Second, the requirements for this criterion of fairness can be very lax. Imagine, for instance, a very remote area where no formal financial institution is active and where informal lenders such as moneylenders charge usurious rates of 15% a month. A microfinance institution decides to charge still exorbitant interest rates of 10% a month, partly because of its high operating costs but mainly because of inefficient management and poor know-how or technologies. If one follows a definition of fairness focusing only on the impact of the loan on its clients in comparison with the previous situation, the 10% margin will be fair even if it only leaves a small profit margin to the borrower.

The **third** widely used approach to the ethical dimension of microcredit interest rates focuses on the demand for credit. It uses high repayment rates and repetitive loans as instrumental proxies of fairness. High repayment and constant demand reflect the affordability of the loans and thus their fairness. The emphasis should be put on the access to credit rather than the interest rate level since it is used in productive activities with very high rates of return. Similar arguments are used in the trade debate. Opponents of the inclusion of fairness considerations in trade negotiations often argue that the agreements are voluntary. Consequently, all agreements that developing countries think would make them worse off will be refused (Stiglitz and Charlton, 2006).

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<sup>2</sup> In some cases many institutions are active in the same area with similar rates; in these cases, the argument should thus be broadened to the microfinance sector as a whole rather than one particular MFI.

Nevertheless, in non-competitive markets, the client may well decide to retake a loan even if the price is exorbitant. However, as in the trade case, the distribution of the benefits may well be unequal. The poor may also lack the bargaining power to influence the price or approach another lender.

The **fourth** and last perspective is a procedural one. Two models of procedural justice can be construed. Under the first model, assuming a well-organized market, fairness only requires that the rules of this market be correctly and impartially applied to all customers.

The second model is based on a comparison of interest rate levels between individual borrowers. To develop this approach, a parallel with the fair wage concept may be helpful. While the concept of fair interest rates has not been debated much in recent literature, the notion of a fair wage is much more present in both the ethics and the economics literature. For instance, in 1885, Belgium already issued fair wage clauses, based on the presumed natural justice of a system of free private enterprise (Johnson, 1938, p. 176). Fair wages for public contracts were to be equal to those paid by reputable employers in the private sector. Similar to fair interest, many interpretations of fair wage have been designed. For Akerlof and Yellen (1990), the fair wage is a perception held by the average worker, presumably on the basis of what has gone on in the past.

An alternative conception of a fair wage recommends that work of equal skill or unpleasantness should be equally compensated (Johnson, 1938, p. 177). Pull (2006) argues that worker fairness conceptions might be similar to what the result of a co-operative game would be. Fairness conceptions are influenced by what a fair arbitrator would have suggested. The fair wage then becomes a function of the outside options of workers, employer commitment to the contractual relations, employment level, returns on investment and the sensitivity of returns with respect to wages.

A parallel with interest rates can easily be drawn. Credit scoring of potential borrowers plays a role similar to the assessing of workers' characteristics. Before accepting a new client or giving an additional loan, financial institutions use credit scoring to assess the probability of their future clients' repayment. As defined by Schreiner (2004, p. 64), "scoring is the use of the knowledge of the performance and characteristics of past loans to predict the performance of future loans".

The clients are scored based on a scale using various characteristics. Even if it is practically very difficult, one could well imagine that an institution, which has a lot of information on its actual and potential clients, proposes loans with interest rates related to the clients' characteristics and scoring. Hence, scales of credit scoring or fair wages both aim at assessing the value or risk of the client or employee.

The main flaw of this approach of fair interest rates lies in the scoring indicators that are used to determinate the interest rate. One may decide to use the indicators best correlated to wage levels or repayment performances. Specifically in microfinance credit scoring, marital status, age, place of residence, and ethnicity are among the characteristics with the highest

predictive value in microfinance (Schreiner, 2004). Some of these indicators may well conflict with our conception of justice. For instance, many databases on wages will see a significant influence of the gender of the worker. Men are very often better paid. Could a man who earns a salary similar to his female colleague claim that his salary is unfair because men tend to earn more? Gender discrimination is very often highlighted in labor economics and is increasingly under attack, but other discriminations may well persist or even be amplified.

Basing credit decisions on a person's profile can also fall foul of the principle of equal opportunity. By taking the current background as given, this approach is likely to maintain basic inequalities in wage or interest rate pricing. Scoring assumes that the future will be like the past (Schreiner, 2004). If it is well used, scoring can be very helpful to manage the loans and the risks faced by the institution. It should however not be used as a measure of fairness.

## CONCLUSION

Many actors in the market for microfinance agree with the second and third perspectives. They argue that lower interest rates should be promoted but not imposed (Helms and Reille, 2004). They should be targeted in the long term. Two traditional instruments to drive down rates are the transparency of the pricing policy and the development of competition in the sector (see Helms and Reille 2006). This approach implicitly tolerates some high interest rates but tries to create a framework that would make them less likely.

It would however be wrong to assume that the whole sector agrees that low interest rates should merely be a voluntary goal rather than an enforceable objective. For instance, based on deontological arguments on the fragility of the clients, Muhammad Yunus considers that MFIs charging higher rates than the costs of funds plus a 15% margin should be considered as imitating money-lending activity (RESULTS, 2006).

Interest rates are dependent on the perspective and the mission statement of the institution. Following the analysis of four different approaches to fair interest rates, it is evident all of them face a trade-off between the interests of financial institutions and those of the clients. The deontological approach puts the emphasis on protecting the clients' interests; it could easily put the institutions at risk. Both the second and third approaches based on the marginal benefit to the customer and on the demand of the loan start from the perspective of the client but intrinsically favor the institution's development. Finally, the procedural approaches to some extent ignore both the clients' and the institutions' interests by simply following guidelines or benchmarks.

Microfinance has been built on the promise of an original association of social and financial sustainability. Financial sustainability has been increasingly promoted over the last decades by many donors and investors. Fair interest rates may as well be important for a "social sustainability" of microfinance. If microcredits end up being judged as an unfair mechanism by observers, social investors, donors or even by the borrowers, the consequences may be

extremely harmful. If microfinance is to be sustainable and remain true to both its social and financial mission, some public actions will be necessary not only to broaden access to credit but also to encourage institutions to charge interest rates that do not exceed certain limits.

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