Rate of interest on microcredit

Post summit rethinking

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IN the early phases of expansion of microcredit (MC), many innovative procedures emerged from the practices of microfinance institutions (MFIs) of Bangladesh. Adopting balanced decisions with respect to ideal rate of interest on MC is also expected to emerge from the MFIs' own experience and judgments. The question of appropriate rate of interest on MC was raised in many of the sessions of the recent regional MC summit held at Dhaka. Eminent personalities and social and political leaders with divergent views on many other issues, expressed similar strong concerns about high rates of interest charged by MFIs of Bangladesh. It has been emphasised that lowering of the rate of interest is critical for the success of MC for poverty alleviation.

The determination of the ideal rate of interest is a complex issue and must be based on an assessment of both demand for and cost of funds for leading. Effective rate of interest on MC is currently in the range of 20 to 30 per cent in most cases.

Those who hold the view that the current rate of interest charged by MFIs is justified, provide one or more of the following rationales.

Obtaining a loan from commercial bank involves extra costs in addition to interest. Such costs include time spent in processing loans which has high opportunity costs in terms of foregone income, transport costs for travelling to distant bank branches, unseen costs etc. These are often higher for the uneducated and poor households. Therefore the poor clients prefer MC and NGO loans even if the effective rate of interest is higher than loans from commercial banks. But higher cost of commercial bank loans, which is often due to their inefficiency or complications, cannot be used to justify high rate of interest of MC.

A number of researches conducted by the author and other researchers show that even after paying such interest, per hour return to labour in MC financed economic activities is higher than the relevant wage rate. Then one may argue that the prevailing rate of interest is acceptable to the clients. But it should be pointed out that a high dose of family labour input and low opportunity of cost of labour, especially because of low wage rate of women imply that the rate of return to capital will be high and is likely to be higher than the prevailing rate of interest on microcredit. However, the fact that poor clients without other options of livelihood accept the high rate of interest on MC should not be used as the rationale for charging such high rates.

One argument for not considering rates of interest charged by Bangladeshi MFIs as high is that these rates are much less than the rates charged by many MFIs in African and Latin American countries. However, one cannot compare Bangladesh's MC situation with other small countries where the scale of MC activities is rather small. In an informal discussion, a participant of the regional MC summit narrated to us her experiences of some Latin American MC activities with high rate of interest which resulted in clients' agitation.

Cost of fund and cost of operation

The other question related to rate of interest is a comparison of MFIs and commercial banks. The rate of interest for poor borrowers of microcredit is usually much higher than the rate of interest for richer clients of commercial banks. Such a difference involves an inequity and therefore, the reasons behind this difference should be examined. Moreover, government has recently taken moves for encouraging commercial banks to lower their lending rates.

The rate of interest charged by the financial organisations will depend on the cost of funds which they lend and the cost of intermediation. MFI's cost of funds is lower than the cost of funds for the commercial banks. The cost is lower for the MFIs because many of them obtain funds from cheaper sources, including international donors. Palli Karma Sahayak Foundation (PKSF) and donors provide them funds at lower rates of interest. Members' savings mobilised by MFIs are likely to be less expensive because they pay their savers a lower rate of interest compared to commercial banks and the savings are not easily accessed by the members. These three sources (international donors, PKSF and members' savings) provide around 68 per cent of funds of MFIs.

MFIs' access to cheaper source of funding does not result in a lower rate of interest on loans because of the high costs of loan operation among poor and illiterate clients. Cost of lending one taka is much higher for the MFIs compared to the commercial banks. This, in turn, is due to the door-to-door services provided by most MFIs and the small size of the loans. The cost of banking among the poor is high because they are not capable of dealing with the usual banking practices and they are unfamiliar with these processes. This is to some extent a legacy of poor deprivation of the poor which takes many forms including lack of access to education and prevailing societal attitude. The incidence of such societal attitude falls disproportionately on the poorer section through the high rate of interest charged for the small loans they obtain.

Interest rate should not be too low

It should be clarified that the rate of interest on MC should not be too low. This will not only make a demand for low cost fund from donors or other sources, but may also affect efficiency of loan utilisation. Clients may then use MC for activities with low returns and may not ensure maximum efficiency of the activity.

In this context the views of some NGO executives may be mentioned. One of them stated that their NGO believes in a philanthropic motive and the rate of interest charged is low (less than 8 per cent). This view needs to be supplemented by arguments that philanthropy may be consistent with a higher rate of interest if the interest earned is used for expanding loans among a large number of poor households and for covering the poorest borrowers. Thus MFIs must strike a balance between helping a small number of poor with larger benefits per borrower through a low rate of interest, and expanding their operations to a larger number of the poor.

Financial sustainability and rate of interest

One of the most important arguments for keeping rate of interest high is to make the MFIs financially sustainable. This means that MFIs' interest earnings must be sufficient to enable them to meet the cost of operation and leave a surplus for further expansion of lending activities. MFIs in this country are making continuous efforts to raise efficiency of operation and to become sustainable. If some low cost fund is channeled for further expansion, some of the MFI's may be able to meet cost of operation even with a lower rate of interest. Lowering of rate of interest through channeling low cost fund for MC expansion cannot be considered as equivalent to subsidy, as long as MC clients pay interest rates higher than the commercial banks' loans.

Reduction of rate of interest

In the informal discussions at the Regional Summit, experienced MF leaders expressed the view that larger MFIs may be able to sustain even if they reduce rate of interest on their loan. But this will adversely affect the activities of smaller MFIs operating in a small area. A reduction of rate of interest can be implemented only through a discussion among the MFIs. The overall impression is that, the market rate of interest of MC can be slightly less than the prevailing rates. Stabilisation of rate of interest at a lower level can be helpful in the overall development of the MFI environment. A vigorous price competition leading to frequent changes in clients' affiliation may have adverse repercussions.

It is unlikely that all MFIs will agree on such a move to cut down interest rates. Reduction of rate of interest by all MFIs for all types of MC cannot be achieved overnight. Some experimental steps may be adopted and lower rate may be offered to specific types of MC and at branches located at poorer geographical regions. Such differential is already being practiced by some MFIs.

When PKSF provides fund to MFIs, especially those who charge rate of interest above some specific level, it should negotiate that the rate of interest charged to individual client is lowered. Donors of MC fund may also play a role in the process.

Bringing down the rates of interest of a few small MFIs who charge rates higher than the large MFIs may not benefit the majority of the MC clients. Moves of reducing the rates should be planned in such a way that the poorest are the first to benefit and even if the reduction is small, it reaches a large section of MC clients.

Arguments have also been put forward that the interest rate question should be viewed as a component of the overall 'regulatory framework' for the MFIs. There is no doubt that such a framework to provide an 'enabling environment' for the MFIs is necessary. But the adoption of steps for reducing rates of interest may be initiated without waiting for the regulatory framework. The practical steps can be developed by the experienced MFIs in consultation with various stakeholders.

It must be highlighted that the MFIs of Bangladesh have pioneered the process of banking with the poor. Further success of banking with the poor depends on the rate of expansion of micro credit, on the repayment performance of borrowers and above all, on the extent to which the loans can help in poverty reduction. A reduction of rate of interest on MC will have a positive impact on all these fronts.

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On Leap Year

How about having this extra day?

A.H. JAFFOR ULLAH *writes from New Orleans*

HOW often would February 29 shows up in the Gregorian calendar? The answer is -- once in every four years. Well, the year 2004 is such a year. We should be happy to know that this is the second year in the new millennium that we are having an extra day. In a normal year, we get 365 days, and that is all. However, in a Leap Year, we get an extra day. This is not a leap of faith that we get an extra day or 'Leap Year Day' for just nothing! There is scientific reasoning behind adding one extra day every fourth year.

If an extra day were not added to the calendar every fourth year, we would run into the trouble of celebrating our all too familiar seasonal festivities. The *Grishmer Chhuti* (summer vacation) would invariably come in the *Haimantic* (mid-October) days in every 754 years. The same thing would happen to Bangla's *Sharodio Parbon* (the *Durga Puja*), which would be celebrated in the summer month of *Baishakh* (April) instead of the usual *Kartik* (October) month. Who would want that? To keep sanity to all these the timekeepers of the western world had devised a very clever method. They opined what's so wrong in adding one extra day once every four years to keep the seasons all intact.

It all started like this. Mother Nature is playing some cruel mathematical tricks with us for a long long time. This trick is to do with Earth's rotation. There is some odd thing about the way the Earth travels around the sun. We all know that the time it takes the earth to spin once on its axis is a day. The time it takes the Earth to complete its annual trip around the sun is a year. Believe it or not, these units of time do not divide evenly! In summary, there is a "Spin Problem." If the Earth would spin a tad slower than its normal spin, the year would be precisely 365 days instead of 365 days, 5 hours, 48 minutes and a little over 45 seconds. Think of it, if the day were just a minute longer than it is, we would not need Leap Year Day. Can one stretch the time a little longer? How about redefining the unit of time? Instead of 1440 minutes making up the day (24 x 60 minutes), define one day equal to 1441 minutes. Our entire problem relating to "Spin Problem" will simply go away. However, since we cannot change the unit of time, the next best thing the Roman pundits have devised is to compensate the world for losing approximately one-fourth day every year. That action however created another problem.

The Romans were smart enough to add one-fourth day to get the 365.25 days Julian Year. However, the discrepancy was still there. It takes the Earth to go around the sun in 365 days, 5 hours, 48 minutes, and a little over 45 seconds. However, the Romans added an extra 11 minutes and 15 seconds to the calendar. This addition has caused the seasons to creep through the calendar once again, only slower, and in the reverse direction. According to a calculation, the Earth would run into the same problem as described earlier but this time once in about 23,000 years. Fortunate for us, things never reached that far. In Vatican, during Pope Gregory XIII's time (1582) the calendar was about ten days out of whack. To correct the problem 10 extra days were added to the calendar, which has brought us thus far without any seasonal problem.

A new rule (Gregorian) was put in place to make sure that the calendar maintains the seasonality. This rule is the following: *If the year is divisible by 100, it is not a Leap Year UNLESS it is also divisible by 400.*

I doubt it very much that any politician in Bangladesh in the right frame of his mind would think about the contribution of this year's Leap Year Day to the GDP growth of our anemic economy. Because most politicians in Bangladesh would never think for a moment how much growth would be impeded by the curse of hartal. How many stomachs would go hungry because of the work stoppage! How many school, college, and university students would sit idle at home not learning the skills that would be necessary for them to become productive citizens.

It turns out that the Gregorian Rule is not a foolproof rule, after all. Following this rule, the Earth's season will again get six months out of whack once in 60,272 years. And to correct this, another rule was created. You might as well call this 'the Modern Rule'. According to this, if the year is also divisible by 4000, it is NOT a Leap Year. Therefore, two thousand years from now in the year 4000, there is not going to be any Leap Year Day. In that year, February would end in 28 days. You may ask: What this correction would do to the calendar? According to a calculation, the Earth's season would again get out of alignment once in every 3.5 million years (to be exact 3 million 565 thousand and 426 years). A long time you might say.

Now that we are getting one extra day in this millennium year, have you considered how would you spend the day? I wished the world would celebrate this date by taking it easy on this special day. We could have taken the day off pondering the mathematical incongruity that was imposed on us by Mother Nature. Nonetheless, that won't be the case. We now live in a very competitive world, indeed. Just the other day, I was reading The Wall Street Journal, the modern day "Bible" of the world of finance in the West. One particular news item really caught my attention. It read: "Leap Day add $ 25.26 billion to the domestic product of USA this year." LeapSource, a Phoenix outfit that provides web-based finance and accounting back office services computed this number. Reading this news item the corporate America is probably heaving a sigh of relief knowing that an extra $ 25.26 billion worth of goods and services would be generated this year due to an extra day that was applied to this year's calendar.

As I was reading the Wall Street Journal's snippet of news, I Immediately juxtaposed the news to what goes on in an ordinary day in impoverished Bangladesh. I doubt it very much that any politician in Bangladesh in the right frame of his mind would think about the contribution of this year's Leap Year Day to the GDP growth of our anemic economy. Why do I say this? Because most politicians in Bangladesh, those who are not elected to any public office, would look at one day thinking -- could I call this day a hartal day? They would never think for a moment how much growth would be impeded by the curse of hartal. How many stomachs would go hungry because of the work stoppage! How many lives would be lost due to hartal! How many school, college, and university students would sit idle at home not learning the skills that would be necessary for them to become productive citizens of Bangladesh.

Four years ago by checking the Commonwealth Online website I calculated that each day would add about U.S. $100 millions to the GDP of Bangladesh. Therefore, if the unscrupulous politicians of Bangladesh would not designate February 29, the Leap Year Day, as a hartal day then, Bangladesh's GDP would grow by another 100 million U.S. dollar.

For the sake of the anemic economy of Bangladesh let me hope that this Leap Year Day goes unscathed without having any hartals (by the opposition parties) or counter hartals (by the ruling party and their alliance). Let the Leap Year Day be a violence free day.

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