Towards a Theory of Fair Interest Rates on Microcredit

Marek Hudon and Joakim Sandberg

One of the most salient ethical debates concerning microcredit pertains to the unexpectedly high rates of interest charged on microloans. Microcredit is supposed to be to the advantage of borrowers in some of the poorest regions of the world, but at the same time commercial institutions need to cover their comparably high costs. This article seeks to find a theoretical basis for a more balanced way of setting prices on microcredit; i.e. a theory of fairness in interest rates. By drawing on both contemporary debates in the industry as well as more general philosophical ideas, the article discusses four main theoretical approaches. In the end the authors favour a combination of consequentialism and liberal egalitarianism which seems able to adequately balance the needs of the institutions with the needs of the clients. However it is also acknowledged that further research in the area is needed.

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Towards a Theory of Fair Interest Rates on Microcredit

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Abstract: One of the most salient ethical debates concerning microcredit pertains to the unexpectedly high rates of interest charged on microloans. Microcredit is supposed to be to the advantage of borrowers in some of the poorest regions of the world, but at the same time commercial institutions need to cover their comparably high costs. This article seeks to find a theoretical basis for a more balanced way of setting prices on microcredit; i.e. a theory of fairness in interest rates. By drawing on both contemporary debates in the industry as well as more general philosophical ideas, the article discusses four main theoretical approaches. In the end the authors favour a combination of consequentialism and liberal egalitarianism which seems able to adequately balance the needs of the institutions with the needs of the clients. However it is also acknowledged that further research in the area is needed.

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1. Introduction

Debates about fairness in pricing are seemingly on the rise on many flanks in contemporary society (Elegido, 2009). Many people are for example upset about how the current patent regime makes various life-saving drugs too costly for poor people, and most recently the debate has surfaced in the fair trade movement which lobbies for fair remunerations of low-income workers (Schuler and Christmann, 2011). However the concern for fair prices as such has a long history (Johnson, 1938). It probably originates with Aristotle’s (1946 [350 BC]) famous comments on how the “true” or natural price of various goods and services sometimes may differ from the market price. Aristotle’s main object of concern was interest, i.e. the price of loans, which he famously denounced as the unnatural fruit of a barren parent.

This article concerns microcredit which is the practice of extending loans exactly to poor or low-income clients; quite often tiny loans (of less than $100) to the very poorest of the global poor. This practice was in a way developed precisely in order to offer fairer prices to small-scale entrepreneurs in developing countries; before microcredit these borrowers had to rely on loans from informal lenders (or “money sharks”) who often can charge rates of up to 1,000% in interest (Armendariz and Morduch, 2005). Moreover, microfinance institutions (MFIs) have proven capable of reaching clients that previously lacked access to financial services altogether; particularly women in rural areas (Morduch, 1999).

However, a fact which rather few members of the general public seem to be aware of is that also MFIs charge very high interest rates. They charge rates that definitely are much higher than what commercial banks in developed countries charge; and indeed they are sometimes similar to those charged by informal lenders. These rates are mainly due to the high transaction and operating costs involved in the upkeep of very small loans. According to the latest figures based on the MIX Market, the average interest rate on microloans is around
30% globally (MicroBanking Bulletin, 2009) and the absolute majority of MFIs charge between 20-60% in interest per year. However in some extreme cases they actually charge much more. The most infamous case is Compartamos, one of the fastest growing commercial MFIs in Latin America, which makes its clients pay around 100% per year plus VAT (Rosenberg, 2007).

As the truth about these rates has become more widely known in recent years, there has been growing ethical concerns about the practices of MFIs – or indeed the “soul” of microcredit – among various outside agents (Hudon, 2009). Branches of large MFIs have been closed by authorities in Ecuador, India and Nicaragua (Counts, 2008). Most recently, Indian branches have also been closed and the central bank of Bangladesh has decided to regulate the industry by imposing a strict ceiling (or cap) on interest levels. Not all of this attention is due to the interest rates but also results from the somewhat fragile status of borrowers. MFIs have occasionally been criticised for their collection practices or their lack of concern for clients that have become overindebted. In any case, ethical issues – and particularly debates on the interest rate levels – are now widely accepted to constitute a major threat to the credibility of the entire microfinance sector (Hudon, 2007).

Given the emergence of this critical and daunting issue, the present article looks to analyze the ethical dimensions of lending to the poor in order to determine what a fair price on microcredit could be. The structure of the article is as follows. Section 2 outlines the main tenets of the debate as it has taken shape in the microfinance industry itself. In Sections 3-6, thereafter, we attempt to deepen the debate by drawing up four more theoretical approaches to fairness in interest rates inspired by a range of philosophical perspectives. Section 3 considers what we call the procedural approach, Section 4 the perfect market approach, Section 5 the credit right approach, and Section 6 the consequentialist approach. Finally Section 7 presents the tentative solution favored by the article’s authors, which is something of a combination of
two of the previous approaches. We try to be clear about why we think that this combination is promising, but also note the need for further research in the area.

Just a quick caveat and a pointer before we start: We are well aware of the fact that interest rates may vary “naturally”, so to say, with factors such as social and economic environments, customs, taxes, currencies, public policies, and even cultural and historical aspects (Conard, 1959; Homer and Sylla, 2005). This means that interest rate levels are notoriously difficult to compare. This problem is probably even bigger when it comes to microcredit since the interest payment as such seldom is the only cost for borrowers. Borrowers may be obliged to provide deposits (also called compulsory savings) during the reimbursement period, or even a few months prior to taking the loan, or they may have to pay various other fixed fees on top of the interest. Besides this the most expensive cost is sometimes not related to the loan itself but to transaction costs due to the loan methodology (Collins et al., 2009).

For these reasons, it is perhaps wise to talk about effective interest rates, or more specifically the annual percentage rate (APR), which includes a wider range of variables such as, e.g., the concrete interest payments, both upfront and consequent, the loan (or service) fee and the contribution to group funds (Ledgerwood and White, 1999). Annual effective interest rates have been advanced by many practitioners, as we soon will see. For the remainder of the article, then, when we talk about interest rates we mean APRs.

2. The contemporary debate on interest rates in the microfinance industry

Prior to the 1970s the interest rates charged from poor entrepreneurs in connection with development projects, particularly in rural settings, were very small indeed. It is difficult to know what the rationale behind this was but one may speculate in that one simply did not
think it socially desirable to charge higher prices from the most deprived, or perhaps the idea was that the poorest would not be able to repay higher rates. In any case, the natural inclination of these original development projects seems to have been to set prices with an eye to the welfare levels of the borrowers.

During the 1970s and 1980s fierce debates took place on the issue of these low interest rate policies. These debates developed hand in hand with the emergence of the kind of commercial microfinance institutions that we have thus far been discussing. Representative of this debate is Adams et al’s (1984) seminal book *Undermining Rural Development with Cheap Credit* and several other works from the so-called ‘Ohio School’ scholars – a group of influential economists at Ohio State University (see Hulme and Mosley 1996). These works were written in response to the existing state of affairs in which the rural poor had access to highly subsidized loans with very low interest rates. Ohio School scholars argued that almost nothing had come out of the many billions of dollars spent on credit programmes targeting the poor since World War II, and the reason for this was that subsidized loans are dysfunctional. Access to cheap credit gives no incentive to save and as a result distorts the way that lenders allocate funds (Adams et al., 1984, p. 75). Furthermore they argued that “low interest rates on loans to rural people end, paradoxically, by restricting their access to financial services” – mainly since few commercial institutions are willing to enter this market without continuous subsidies (Von Pischke, 1983, p. 176). Finally, they argued that many had underestimated or neglected the fact that low rates would create an underdeveloped financial infrastructure.

The Ohio School scholars agreed that commercialization of development loans inevitably would lead to poor borrowers having to pay higher interest rates. However their motto was that “access is more important than price” – that is, having reliable access to loans is more valuable for the borrowers than having access to cheap, large or long-term loans (Adams and Von Pischke, 1980). Moreover a common idea seems to have been that it is
essential to guarantee the continued existence of the relevant institutions, since if the institutions were to fail to be profitable and go bankrupt the clients would end up with the moneylenders who charge even higher rates. It is in this sense that they argued that low and subsidised interest rates can be counter-productive. Rather than focusing on the borrowers’ “need” for cheap credit, then, they argued that MFIs should offer "cost-covering interest rates" which would enable them to continue to operate (Adams and Von Pischke, 1993).

We believe that the ensuing debate on interest rate levels within the microfinance industry – that is, from the 1990s and to the present time – actually can understood as a continuous search for balance between to the two elements above: i.e. the welfare of the customers on the one side, and the imperative of building strong institutions on the other. Following Woller et al. (1999), it has become common to characterize the debate as one between the “institutionist” and the “welfarist” camp.

On the one hand, welfarist proponents – such as e.g. Nobel Peace Prize Laureate Muhammad Yunus – stress the idea that the overarching goal of microfinance must be the clients’ personal development. Interest rates should therefore be set from the perspective of helping the impoverished, rather than supporting the pure sustainability of the lending institutions. On this view, then, the emphasis is on that the rates should be low enough to give some margins to the borrowers so that they can develop their microbusinesses. While proponents of this view have been critical of high interest rates ever since the 1970s, their criticisms have really intensified during these last years (Rosenberg et al., 2009).

On the other hand, institutionist proponents – such as e.g. the Consultative Group to Assist the Poor (CGAP), a microfinance donor organization housed at the World Bank – put emphasis first and foremost on the MFIs themselves and their financial sustainability. In line with what D. Adams and J. Von Pischke suggested they consider access to be more important than price; and it is indeed thought that poor households can afford very high rates (CGAP,
Moreover the ethical justification of microcredit is partly thought to stem from a comparison with the prices charged by informal lenders and pawnbrokers; as noted above microcredit is normally cheaper than what the borrowers used to pay to finance their activity (McKenzie and Woodruff, 2006; de Mel et al., 2008).

Now, which side in the debate above is correct – is there something ethically wrong with today’s interest rates on microloans or are they acceptable? Well what really characterizes a fair interest rate on such loans? In order to make some headway on this issue, we will now present and discuss four more general philosophical approaches to how interest rates should be set which we think that we have distilled from the contemporary debates. Most commentators are unfortunately very vague on the philosophical underpinnings of their arguments or views. But these approaches represent an interesting cross-section of different philosophical traditions, in any case, and we take them to be the main theoretical contenders in the context.

3. The procedural approach to fairness

According to a first kind of perspective, which is fairly common in the business ethics literature, the fairness of a given market transaction depends primarily on the degree of voluntariness of the transacting parties and their consent to the terms of the transaction. Applied to the microcredit context this means that any interest rate is fair as long as it is the result of a free negotiation process where neither the lender nor the debtor is coerced or deceived in any way. We may call this the procedural approach to fairness in interest rates. This approach could be said to be the default, or “no theory needed”, option in the circumstances since it represents the idea that only the transaction parties themselves can decide whether a given interest rate is fair or not. Proponents of this view may legitimately
ask: Who are we as commentators to moralize over interest rate levels from afar? Should we not let this be an issue strictly between the MFIs and their clients?

We start with the procedural approach here for two reasons: firstly because we believe that it underpins a central argument from proponents of the institutionist view; namely that high repayment rates somehow indicate borrowers’ acquiescence to the current interest levels.

It is an intriguing fact about today’s microfinance industry that the average repayment rate on microloans is extremely high. According to the MicroBanking Bulletin, which provides financial information on more than 1000 MFIs worldwide, the average loan loss ratio on microloans was as low as 0.8% in 2009 (MicroBanking Bulletin, 2009) – a figure well below that of most commercial banks. Now according to some commentators, the fact that clients almost always pay back their loans (including the interest) – and indeed typically come back for more – can be taken as an (at least preliminary) justification of the interest rates set by the relevant MFIs.

This is a central argument in CGAP’s official advice on interest rates to MFIs, for instance, which contains a section on “The Theory and Practice of ‘Exorbitant’ Interest Rates”. Part of this section reads:

For the past ten years, the author of this paper has been asking in conferences, courses, and (more recently) Internet newsgroups whether anyone present has ever heard of a microfinance program that ran into trouble by driving away clients with interest rates that were too high. No one has yet pointed to a single example. This remarkable piece of data does not indicate that there is no limit to the interest rates that the microcredit market can bear, but it does suggest that the limit is probably considerably higher than what even the more aggressive MFIs are presently charging. (Rosenberg 2002, p. 10)
We will return to the issue of just how much clients can pay in the next section.

The second reason for why we start with the procedural approach is that it also seems to be implicit in a number of initiatives concerning transparency in interest rate setting which seemingly stem from the welfarist side. A whole range of recent initiatives in the microfinance industry – such as the MIX Market database itself, MFTransparency and the Smart Campaign – all include a call for increased transparency in pricing on microfinancial products and services. The most straightforward reason given for why transparency is important is that MFIs target very poor clients who frequently are illiterate and therefore need further help to understand the contracts into which they enter. But of course, transparency is also very important for other stakeholders such as donors and investors who evaluate the social and financial performance of MFIs, and regulators or competitors wanting fair competition. Most of the initiatives in question focus on educating MFIs on how to calculate effective interest rates or the APR; as we have already said, when comparing interest rates it is vital to not only include the basic interest rate charged on the loans but also the fees, mandatory savings or additional burdens that clients cannot easily identify.

The call for increased transparency implicitly accepts the procedural approach to fairness in interest rates since it focuses exactly on making sure that clients know what they are getting themselves into, and that they therefore accept the relevant contracts freely and voluntarily. As long as MFIs price their loans with full transparency, then, and clients keep coming back for loans, interest rates are fair.

Now we suggest that the procedural approach to fairness in interest rates indeed has some promising aspects – at least if it is supplemented with a sufficiently rich view of what it means for clients to consent to the contract terms. Many commentators have stressed the value, either inherent or instrumental, of more active participation by clients in the loan
process (Elkin 2004, Guérin 2004, Labie 2004). If a central goal of development in general and microfinance in particular is the empowerment of the poor, for instance, one may hold participation in the loan process (or indeed in loan contract negotiations) as a kind of financial empowerment. Furthermore such participation may have positive side effects both for the relevant MFIs and for society in general. To the extent that the procedural approach could be viewed as an ideal of increased borrower participation in the loan process, then, we believe that it is on to something important. Moreover given that loan contracts indeed represent the will of both MFIs and their clients, we agree that one would seem to have at least prima facie moral reasons to respect them. This is so because autonomy is inherently valuable and any kind of paternalism (acting in the interest of clients against their will) therefore requires further justification. This is an important moral principle with the procedural approach correctly highlights.

In the end, however, we believe that the procedural approach has more problems than strengths – indeed we contend that calls for increased transparency do not take us far enough towards the goal of fairer interest rates on microloans exactly since it implicitly assumes the procedural approach.

The most disturbing problem in this context is that it simply seems highly improbable that many loan contracts in today’s industry represent borrowers’ genuine will. When the procedural approach talks about coercion, it should be noted, it seemingly only cares about very direct and in-your-face forms of coercion – that is, contracts are fair as long as MFIs do not use direct force or the threat of force, or as long as they do not actively deceive people with opaque pricing procedures, to ensure repayment or to get more clients. Now it is probably correct that very few clients are coerced in these ways, and that they would be even fewer with increased transparency in pricing. Although there are at least some reports of such behaviour on the part of MFIs: in the Andhra Pradesh incident in 2006, for instance, there are
reports of such obviously unethical practices as “confiscating title deeds, using intimidation and abusive language, and combining multiple products like savings, insurance and loan to ensure prompt recovery” (Shylendra 2006, p. 1959) – and more generally, there has also been much debate about the possibly abusive nature of group lending techniques (Harper, 2007; Rankin, 2002).

Our point is simply that there besides these forms of direct coercion also are more indirect and elusive forms. And it does not seem implausible to assume that various kinds of structural coercion create a situation of less than perfect voluntariness in almost all cases. One may safely assume, first of all, that borrowers are forced by their impoverished situation as such to do something, well anything, that can bring food to their table and pay for their housing. Secondly that choice of activity is restricted due to a lack of acceptable alternatives – in many cases, for instance, the poor’s only alternatives may be to take out microloans or go to the local moneylenders (since they have no money and there is no social security). Now if they decide to go for the microloan, the unfortunate reality is that they often will have only one or two MFIs to choose from, and these will probably give them the same deals anyway. This is so because the microfinance industry is far from competitive in most places and there is no external pressure on MFIs to adapt. And finally if and when they approach their chosen MFI, of course, the borrower has no collateral to bargain with, and also typically little knowledge of financial matters. For these reasons borrowers will realistically have extremely little power in “negotiations” about loan contracts.

We take the considerations above to suggest that the procedural approach, in a morally problematic way, sides too much with the needs of the institution rather than the needs of the clients – and therefore it does not reach the kind of balance that we are looking for. One simply cannot take borrowers’ acceptance of the loan terms at face value as proponents of the
institutionist side sometimes do, since the important question is not whether the poor pay back but why they do so.

4. The perfect market approach

Can the procedural approach somehow be revised to avoid the problems above? Judging from the literature it seems that the natural reaction in the present context – at least to most economists – is to characterise the problem as one primarily concerning market imperfections; that is, deviations from the theory of perfect markets. As noted above the lack of competition in the microfinance industry is a central problem; in non-competitive markets the client may well decide to retake a loan even if the price is exorbitant but the distribution of the benefits may well still be unequal, and the poor may also lack the bargaining power to influence the price or approach another lender. The second approach then suggests that the fair interest rate is the one that MFIs and their poor clients would agree upon in a (sufficiently) perfect market. Exactly how such a market should be defined may be up to debate, but full-scale competition is obviously an important part. And perhaps one could also “define away” many of the other structural problems noted above – one may for instance hold that all parties must have full knowledge of their options, and also a real choice as to whether they want to make a given transaction or not. We may call this the perfect market approach to fairness in interest rates on microloans.

This approach is also typically used by proponents of the institutionist camp, although it may be noted that it often is used to point out problems with the route that the microfinance industry currently is taking. Reflecting on their own part in the development which culminated with the Compartamos case in 2007, for instance, CGAP at one point interestingly write:
Since our founding in 1995, CGAP has been vocal about the need for interest rates that are high enough to cover costs, but we have been less emphatic about the loss to clients when interest rates are driven by inefficiency or exorbitant profits. We never made concrete predictions about how quickly competition would fix these problems, but we were probably too optimistic on this score. The Compartamos IPO gives all of us an opportunity to take another look at these questions (Rosenberg 2007, p. 15).

The suggestion that increased competition is a key in solving the problem of exorbitant interest rates gains further support by Fernando (2006). He suggests that donors must focus on measures that will decrease interest rates in a sustainable manner, encourage the entry of various kinds of institutions, and stimulate more competitive markets.

We take the perfect market view to be an improvement in comparison with the first and strictly procedural approach. On this second view, namely, it is possible to ethically criticise at least the most aggressive MFIs such as Compartamos. What these companies are doing wrong is here to knowingly exploit the fact that the market is less than perfect – that is, that there is embarrassingly little competition in many places, for instance, and that borrowers are in dire need of funds. Furthermore, it may be noted that the perfect market approach can give rather practical advice on how one best curbs the problem with exorbitant interest rates, which obviously is something positive. This is indeed advice that should be fairly straightforward to anyone with a basic degree in economics – namely to promote an enabling environment, encourage the entry of further agents and control inflation.

Having said this, however, we suggest that also the perfect market approach in the end has certain devastating flaws. A first such flaw is that it cannot guarantee that the interest rates would be much lower than they are today even on a perfect market. Exactly what is the
interest rate likely to be if we remove present imperfections in the market? This is a hugely complex issue but, interestingly, there are at least two considerations which suggest that interest rates on microloans could be very high even on a perfect market. Firstly, the administrative costs associated with extending a large amount of very small loans are immense (more on this below). Secondly, there are indeed reasons to believe that some poor people themselves are likely to accept much higher interest rates than what non-poor typically would, even on a perfect market. According to what economists call the “law of diminishing marginal returns on capital”, relative returns on investments are higher the less capital you have to start with. What this means is that, to use an example, the tycoon who invests yet another £1,000 in his already proven company is likely to get much less out of this extra money than the temp who uses £1,000 to start his first micro-business. But since interest rates are exactly relative, this also means that the temp will be able to handle a much higher interest rate than the tycoon.

Now it should be noted that the “law” above is a generalisation, and that empirical studies have identified settings relevant for MFIs (e.g. in agriculture) in which it seems incorrect (Armendáriz and Morduch 2005). Furthermore the law only considers the demand-side (borrowers) and not the supply-side (MFIs). In any case, the two considerations above are fairly common arguments from the likes of CGAP in defence of today’s high interest rates on microloans. But we suggest that they are problematic to the extent that great differences in the prices that the poor and the non-poor get, unless they are justified by sufficiently weighty moral reasons, feel inherently unfair to most people. We will return to this egalitarian intuition below.

A second problem with the perfect market approach is that it is possible that there are negative side effects from increased competition in the microfinance industry. According to some recent empirical studies, a higher concentration of MFIs in a given region is associated
with multiple loan taking and thus probably an increased risk of over-indebtedness among clients. MFIs would also tend to focus on larger loans to wealthier clients (McIntosh et al., 2005). The theoretical reasoning in connection with these results is that more aggressive marketing from MFIs in some cases leads to borrowers taking out loans from multiple sources and thereby becoming over-entrenched in debt. Furthermore competition may lead to a focus on the “upper poor” (the relatively wealthier) instead of the “ultra-poor” (the relatively poorer) since it simply is cheaper to handle a fewer amount of larger loans than a greater amount of smaller ones. Interestingly, one may say that this last point in effect means that competition makes MFIs behave more like standard commercial banks than like development-oriented organisations.

One may perhaps take these last considerations to exemplify a more general problem for the perfect market approach, namely that it to some extent tries to “smuggle in” a concern for clients without really referring to their situation directly. Proponents of the present approach typically argue that subsidised and low interest rates would distort the market and hinder the entry of competitors. Instead of subsidising loans and thereby supporting the customers directly, then, emphasis is on building strong institutions and competitive markets which are thought to drive interest rates down indirectly. But one may wonder what happens if this is not the case? Our point is simply that lower rates at best are unintended by-products in institutionist thinking; the overarching concern is the best interests of the institutions.

In conclusion, then, also the perfect market approach fails to reach the kind of balance between the needs of clients and institutions that we are looking for. The perfect market approach is still too much in the hands of institutionists.

5. The credit right approach
The considerations above suggest that we may need to look in a completely different direction in order to find a more plausible theory of fairness in interest rates on microcredit. At this point it may be interesting to turn to the perspective on interest rates defended by Muhammad Yunus and others from the “welfarist” camp. It should be noted that Yunus (1998; 2007) talks about microcredit in general, and also interest rates in particular, in a language that is quite different from that of the economists above. Yunus famously argues that access to credit should be considered a human right – that is, that it should be included in the United Nations’ Universal Declaration of Human Rights. The reason for this is that everyone should have a right to unleash their entrepreneurial capacities and to strive for personal development through self-employment. Yunus argues that it actually very seldom is lack of entrepreneurial spirit which prevents poor people from lifting themselves out of poverty; more often it is lack of the money to get things started.

Now the credit Yunus is talking about here is not just any kind of credit but affordable credit (Hudon, 2009). Yunus has a rather straightforward classification system for what he considers to be affordable credit. Truly poverty-focused microfinance programs, he says, “charge interest rates that fit into one of two zones: the Green Zone, which equals the cost of funds at the market plus up to 10 percent, and the Yellow Zone, which equals the cost of funds at the market rate plus 10 to 15 percent”. But beyond that, MFIs “that charge an interest rate higher than the Yellow Zone operate in the Red Zone, which is moneylenders’ territory” (2007, p. 68). If we put the two ideas together, then, Yunus seems to be arguing that poor people have a human right to credit with a rate of interest that is less than 15% over and above the cost of funds; that is, the interest rate which the MFI itself gets on loans from governments or commercial banks.

If part of what was problematic with the perfect market approach above was that it could not guarantee sufficiently low interest rates for the poor, one may say that this is exactly
what Yunus’ approach sets out to do. According to what we may now call the credit right approach, poor people simply have a right to affordable credit – that is, they have right to (have access to) credit with a price that probably is considerably lower than what most MFIs charge today. Corresponding to this right there are certain ethical obligations on the part of both lenders and governments; at least, guess that the basic idea is that MFIs act unethically if they fail to give clients a sufficiently low interest rate (because this violates clients’ rights). And furthermore governments have various political obligations; for instance an obligation to protect the poor from violations of their right to credit – and (possibly also) an obligation to create an environment where everyone has access to credit.

On one interpretation, we suggest that some countries already may be trying to put the credit right approach into practice. Helms and Reille (2004) lists about forty developing and transitional countries that had introduced various kinds of interest rate ceilings prior to 2004. Now similar regulatory measures have become even more popular during the last couple of years due to the financial crisis and an increasing fear of overinbtededness. A few countries have simply warned their MFIs that they voluntarily should decrease their interest rates. However Bangladesh has decided to cap interest rates and a sub-committee of the Reserve Bank of India has suggested imposing a 24% cap on MFIs’ interest rates plus a 10% cap on their mark-up over and above borrowing costs.

The credit right approach obviously represents a more egalitarian political philosophy than the perfect market approach does, and one which focuses on the legitimate claims of people in the lower end of society’s ladder. We believe that this is a clear advantage in the present context. As we noted above, most readers will probably agree that the disparity between what the poor and the non-poor currently have to pay in interest on their loans somehow feels inherently unjust. We think that Yunus formulates this egalitarian intuition rather nicely when he writes: “Isn’t it outrageous that low-income people who are struggling
to make ends meet are the ones who have to pay the most for basic financial services – when they can get access to those services at all?” (2007, p. 50). Now it should be admitted that the simple fact that so many people share this egalitarian intuition does not make it true in and of itself. However we contend that the special context of microcredit makes it quite natural to attach much weight to egalitarian concerns. After all, the whole idea of microcredit in the first place is exactly that it is supposed to be to the advantage of poor borrowers.

We believe that the credit right approach is particularly attractive as a theory of how interest rates would be set in an ideally just society. However it should be noted that the approach is not without problems. For instance, a number of commentators have recently argued against Yunus’ idea of credit as a human right (Morduch, 2009; Sorell, 2011). A central argument in this literature is that access to credit at best can have instrumental value for borrowers – that is, what the poor really want is housing and clothing and such things and not access to credit *per se*. But if this is the case, the critics suggest, it seems strange to insist on a human right to credit *per se*. The relevant human rights must then be the rights to housing and clothing, and access to affordable credit should at best be considered a political instrument which one may or may not use for securing those more fundamental rights.

A different kind of criticism concerns the practicalities of Yunus’ idea. It is often argued that interest rate ceilings are a very rough political instrument and that they have a wide range of negative side effects. According to Fernando (2006), caps on microcredit interest rates will make it harder for MFIs to raise capital, both from their own operations as well as from external sources, which in turn leads to less willingness to expand and more focus on short-term loans to the “upper poor”. Some commentators indeed argue that not even providing subsidised loans to the poor is a very effective way of tackling the problem of exorbitant interest rates. According to Helms and Reille (2004), for instance, governments and the international community do better by focusing on improving the infrastructure of the
countries where microfinance borrowers live: i.e., telecommunications, roads, education. This will namely have a wide range of positive effects in terms of alleviating poverty, and at the same time lead to lower interest rates on microloans indirectly, since it will reduce certain key costs for MFIs.

We believe that both of the arguments above should be taken seriously, but they need not be totally devastating for proponents of the credit right approach. If talking about human rights is problematic one could instead talk a bit looser about legitimate justice-based claims. The poor have legitimate claims to affordable credit to the extent that it may help them out of poverty. Furthermore there are plenty of ways in which either the government or other parties could meet those claims and proponents of the present approach need not insist on any more specific way – that is, they need not insist on interest rate caps or indeed any policy which targets interest rates directly. The point could simply be that some of these agents have moral responsibilities to do the things which most effectively protect or promote the legitimate claims of the poor. We will return to develop this point in section 7 below.

In the end, however, we believe that there is another problem with the credit right approach which is more devastating. If the interest rate to which the poor have legitimate justice-based claims is very low there is an apparent risk that not all relevant agents can afford to provide credit in sufficient quantities. That is, the institutions as such may not afford to give affordable rates. As we noted previously, a common argument from the institutionist side is that MFIs need to charge “cost-covering” rates in order to be financially self-sustainable – at least as long as there is no steady source of subsidies or grants to rely on (which there very seldom is). Now one may of course argue that governments and the international community have a responsibility to step in and secure the poor’s right to affordable credit if and when MFIs are unable to do so themselves for this reasons. But we believe that it also is wise to be pragmatic on some level and realise that both governments and MFIs may have burdensome
costs and other obligations which legitimately prevent them from being able to see to the claims of the poor.

In sum, then, it would seem like the credit right approach actually goes too far in its support for the needs of the clients over the needs of the institutions. In this sense also the credit right approach fails to find the necessary balance. So are there any further possibilities?

6. The consequentialist approach

The final approach that we wish to discuss here is something of our own construct which draws on the normative ethical theory of consequentialism. According to the consequentialist approach to fairness in interest rates on microloans, the ultimate justification of microcredit is obviously its good effects; especially the amelioration of the (financial) situation of the poor. All of the engaged agents’ goal should therefore be to try to make there be as much of this good effect as possible. Now, decreasing interest rates may be one way of doing this since it rather straightforwardly lets the poor keep more of their money – which in turn may increase their chances of lifting themselves out of poverty. On the other hand one must also be aware of how the relevant institutions work: as noted above, MFIs can seldom find stable sources of subsidies and need to cover their costs. In a sense, that is, giving away too much now may make it more difficult to give away anything later. On the consequentialist approach, the fair interest rate is here simply the one which weighs these concerns against each other and maximises the overall utility – that is, the balance which makes the outcome the best.

Few commentators in the microfinance literature defend this approach explicitly; or they at least seldom mention consequentialism as such. But in any case we believe that it is close to some central ideas that are going around. Formulations that go in this direction can indeed be found on both sides to the debate on commercialisation in microfinance. For
instance the Vice-President of Accion, one of the largest microfinance NGOs in the US, defines fair pricing as that which “allows the institution to operate as a (on)going concern, but at the same time is as low cost to the customer as possible” (Accion 2004). Furthermore the Accion ‘consumer pledge’ states that “interest rates will not provide excessive profits, but will be sufficient to ensure that the business can survive and grow to reach more people” (Accion 2004). What seems to be sought in these quotes is exactly a balance between the needs of the poor and the need for MFIs to continue to exist.

Now the statements above are obviously quite vague; and indeed the theory of consequentialism as such is infamously plastic (more on this below). In order to avoid confusion, we wish to stress that the consequentialist approach as we understand it cannot be used to defend just any kind of “balance” between the needs of clients and institutions. More specifically, we suggest that the consequentialist approach only can justify setting interest rates so to cover what we may call necessary costs – that is, costs that it is absolutely vital to pay in order to ensure the survival of the institution. It should be noted that consequentialism seeks the maximisation of utility – that is, institutions are morally required to do their best to cut unnecessary costs in order to ameliorate the situation of their clients as much as possible. It is not completely clear that this is what Accion means. On one understanding of Accion’s appeal to “ongoing concern”, at least, this simply includes all current costs, and also other (unnecessary) costs associated with perpetual growth and making the MFI attractive to commercial investors. But interestingly, then, the consequentialist approach seems to side with the perfect market approach here in forbidding MFIs to transfer unnecessary costs onto the clients.

We believe that what most straightforwardly sets the consequentialist approach apart compared to the previous approaches is that it so explicitly seeks to find a balance between the needs of the clients and the needs of the institutions. And compared to the credit right
approach, it certainly seems to be more realistic if we aim at sustainable provision of financial services for the poor – as we argued above, it seems fair to assume that both governments and MFIs may have burdensome costs and other obligations which sometimes legitimately prevent them from being able to see to the justice-based claims of the poor. MFIs are thus doing the right thing and should not be morally castigated for setting the interest rates wherever they set them as long as they give as much as possible back to their clients after having covered their necessary costs. And the same could then also be said for governments – they should not be criticised as long as they, to the best of their (current) ability, ameliorates the financial situation of the poor through either subsidies of interest rates or something else.

However also the consequentialist approach has philosophical problems which are troubling in the present context. First of all, it should be noted that we at the end of the day cannot be absolutely certain that utility is maximised if, e.g., MFIs only avoid all unnecessary costs. Since consequences by definition are events in the future and it is impossible to know with any certainty what the consequences of a certain policy or action will be, it would seem that it also is impossible to give concrete guidelines on how to find the utility-maximising balance between the needs of clients and the needs of the institutions. This is a serious flaw of the consequentialist approach which many philosophers have noted. We take this problem seriously and therefore admit that we cannot completely rule out the possibility that consequentialism actually could justify, e.g., commercial MFIs’ attempts to become more attractive to mainstream investors partly through charging very high interest rates. But we simply find it very unlikely that this maximises overall utility.

A second and somewhat different problem is something which the present approach shares with the perfect market approach; namely that it obviously is unable to guarantee that the fair interest rate will be much lower than what is common today (and what feels politically unjust). It indeed seems quite natural to assume that interest rates would remain fairly high
even if all MFIs suddenly were to fulfil all of their consequentialist obligations, since the costs involved in providing a great number of microloans to poor people still are very high. According to the latest statistics from the MIX database, e.g., what really drives interest rates up are the operating expenses and cost of funds of MFIs. Average profits even among sustainable MFIs are only at about 14% of the interest yield, which means that even if an MFI were to eliminate all profits it would only be able to reduce its interest rate with roughly one-seventh (Rosenberg et al. 2009).

A third problem is related to this, namely that it may feel unfair that even some of the necessary costs ultimately are transferred to and have to be borne by the poor clients. We believe that the perfect market approach, for example, is on to something when it suggests that costs arising from poorly functioning markets should not have to be borne by clients. Similarly one may think that it is not the clients’ fault that they live in remote rural areas where communications are expensive and therefore also loan administration is costly. But on the consequentialist approach, it would seem, such factors may be unavoidable and can therefore indeed determine what the utility maximising interest rate will be, and these costs will most probably have to be borne by the clients.

The problems above are important in the present context. But where do they then ultimately put us?

7. Our own solution: A combination of rights and consequences

Our aim in this article has been to find theoretical input on how to set prices on microcredit in a more balanced way; i.e. to get closer to a theory of fairness in interest rates. The time has now come to say a bit more about what we take to be the most plausible view in the present context. As already indicated, we find that there are serious flaws in both the procedural and
perfect market approaches. However we can see definite possibilities in both the credit right and consequentialist approaches. Our own solution is therefore to try to combine these latter two perspectives. We acknowledge that combining views sometimes can lead to more problems than solutions, and it obviously always makes the philosophical foundation more complex. Nevertheless we think that there is a place for balance and compromise also in philosophy.

To get back on track with the issues, it may be noted that the two final problems afflicting the consequentialist approach above – that it does not guarantee lower rates and that clients will have to bear too much of the costs – ultimately have to do with justice-based intuitions. For this reason, then, we suggest that the consequentialist approach is most plausible in combination with the credit right approach. More specifically our suggestion is that the latter is the most plausible principle for how interest rates would be set in an ideally just society, or roughly what the overarching politico-philosophical goal of the industry should be. However the consequentialist approach is probably a more plausible principle of the ethical responsibilities of (or criteria for moral praise and blame concerning) the agents involved in the contemporary microfinance industry.

During the last decade, the microfinance sector has probably put more emphasis on building profitable institutions than on decreasing the final cost to the borrowers. But recent events in Bangladesh, Nicaragua and India – as well as the launching of major campaigns like the Smart Campaign – have shown that the balance will have to evolve if microfinance wants to remain acceptable and sustainable. We believe that there are many things which contemporary MFIs themselves both can and should do in order to change this. Most importantly they ought to cut down on unnecessary costs in order to avoid passing these on to their poor clients. Armendáriz and Morduch (2005) suggest that operational inefficiencies were a big part of why Compartamos charged so high interest rates: most strikingly they had
very high staff turn-over. Now it is true that microcredit simply is a lot more expensive than conventional credit due to a whole range of costs which probably are beyond MFIs’ control: e.g. poor societal infrastructures, high cost of funds, etc. But this does not mean that there is absolutely nothing that they can do in order to be able to reduce their rates.

One strategy often suggested by donors and practitioners is cross-subsidies. The goal of cross-subsidies is to reach out to wealthier clients (by giving them larger loans) to finance a larger number of poor clients whose average loan size is relatively small (Armendàriz and Szafarz, 2011). Providing both large and small loans does not really bring down costs, but the idea is that it can generate more income for the MFIs (Stuart, 2007). MFIs would be able to use the margin generated by their services to the relatively better-off in order to serve the very poor and most disadvantaged. They could then, for instance, decide to lower interest rates on the range of their products targeting very poor clientele. Alternatively they could provide a standardised product in both urban and rural areas even if operating expenses would be higher in the rural ones.

Cross-subsidies quite obviously make sense in terms of social justice. Furthermore they would make the relevant institutions less dependent on access to governmental grants or other kinds of subsidised funds which many contemporary MFIs use in order to serve their poorer clientele. Subsidies are scarce and there is still a vast group of people excluded from the world of finance, so cross-subsidies could be an additional source of funds. Now one should of course not be blind to potential drawbacks. First, as suggested by Stuart (2007) cross-subsidization takes place within a large but limited customer base – the poor. The pricing, geographical targeting, and service delivery methodologies of MFIs often make their services less attractive or simply not interesting to middle-income and wealthy individuals. As a result, any cross-subsidization within the organization’s customer base flows between
groups that are poor. One could wonder if these additional margins should not come from non-poor clientele.

To this, we believe that many MFIs would respond that they are not experienced enough, or simply not willing, to serve non-poor clientele. Indeed, while this strategy may be attractive for MFIs and enable them to diversify their sources of funds, there is also a risk of “mission drift” which is a big debate topic in the recent microfinance literature (Mersland and Strøm, 2010). Once they start serving a less poor clientele, MFIs may well ultimately be tempted to keep working with this “easier” segment of the population. Moreover, the combination of a development logic related to poverty alleviation and a more commercially oriented logic of the less-poor is very difficult to manage in MFIs (Battilana and Dorado, 2010). In conclusion, we believe that cross-subsidies are part of the solution but must be managed with a lot of precaution to avoid mission drift and internal conflicts.

Besides cross-subsidisation, operating expenses and inefficiency could also be decreased through various kinds of innovation. Mobile banking is a typical example of how technological innovation could decrease both management and infrastructure costs in very remote areas. Furthermore the forming of partnerships with traditional banks or other NGOs could allow MFIs to benefit from the expertise of other kinds of institutions.

The measures above should be able to reduce interest rates on microcredit to at least some extent and, as noted, we believe it is MFIs moral responsibility to do this (along the lines of the consequentialist approach). However there is most likely a limit to exactly how many costs they will be able to reduce. At this point, we have argued that the responsibility more fruitfully should be said to lie on governments and the international community (along the lines of the credit right approach). And there are certainly many things which these agents can do to alleviate the situation of poor microcredit borrowers. A traditional strategy is to simply give subsidised credit lines. Many donors and socially responsible investors have
already started to provide cheaper funds to MFIs. While some have warned against a risk of competition distortion of these subsidised credit lines, they are still a relatively easy, and not so expensive, strategy to decrease total costs. Nevertheless, some have warned against a “crowding-out” effect. They argue that many of these subsidised funds are given to large and already profitable institutions that could well be financed by commercial players, while many smaller institutions would need these funds. Moreover, it is difficult to tell whether the institutions benefiting from these funds really end up decreasing their interest rates rather than increasing their profitability.

Guarantee funds, financed by donors, could also help MFIs to lower their cost of funds. These funds help creditworthy institutions to get access to some alternative sources of funds while they lack real track records or the financial collaterals requested by the provider of funds. Thanks to these guarantees, part of the default risk is supported by the donor who could also help MFIs to gain access to cheaper sources of funds. Finally, donors could make sure that MFIs benefit from modern systems management and, more generally, from all kinds of techniques or knowledge which help to decrease costs.

As suggested above, we believe that donors have a bunch of instruments or policies to implement that could decrease interest rates paid by the clients of MFIs. While the institutions themselves obviously are at the front line, since they are the one actually deciding the interest rate level, donors could well facilitate the decrease of interest rates.

8. Conclusion

One of the most salient ethical debates concerning microcredit pertains to the unexpectedly high rates of interest charged on microloans. Microcredit is supposed to be to the advantage of borrowers in some of the poorest regions of the world, but at the same time commercial
institutions need to cover their comparably high costs. In this article we have sought to get closer to a theory of fairness in interest rates when lending to the poor. We have presented four major theoretical perspectives on the issue, with inspiration taken both from the contemporary debates in the microfinance industry as well as more general philosophical debates on fairness. Our conclusion is that the procedural and perfect market approaches manage to pinpoint some key concerns related to fairness and microloans but that they also have severe flaws. Our own solution is ultimately to favour a combination of consequentialism and liberal egalitarianism. As long as MFI’s are doing all they can to ameliorate their clients’ situation they are ethically in the clear. But there is also a need to continue the political discussion about what interest rate levels the poor have legitimate justice-based claims to.

Now it should be noted that we mainly have pointed out a direction for future thinking here, and we do not claim to once and for all have settled the issue of fairness in interest rates on microloans. A lot more research is needed on all parts of the debate on interest rates in contemporary microfinance. More specifically, we hope that we have shown the great need for further theoretical research on the politico-philosophical perspective on microcredit, as well as further practical research on ways in which MFI’s can cut unnecessary cuts.
References:


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