The Effects of the Interest Rate Ceilings on the Micro Lending Market in South Africa

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Working paper: 2002-02

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Abstract

Interest rates are a topical subject in the micro lending industry in South Africa. The micro lending industry has been accused of charging usurious interest and exploiting the consumers. This has led to the Department of Trade and Industry passing a Usury Act with an aim of protecting the consumers. The Act imposes interest rate ceilings on loan finance provided by money lending institutions. These ceilings are proposed to be linked to the prime rate. Given this, it is not possible for micro lenders to charge full-cost recovery interest rates. This paper tries to highlight the effects of interest rate ceilings on the micro finance market. It argues that the biggest cost component of microlenders is administration costs and not the cost of capital, thus linking ceilings to the prime rate is illogic.

Introduction

Access to loans and credit facilities has been a major problem for a large portion of South African society (Aveyard, 1999). The problem is most significant amongst the disadvantaged and especially in rural areas where the majority of people don't have access to formal banking services due to lack of collateral. The lack of physical access to banking facilities and the unattractiveness of this large section of society to the banking sector have contributed to millions of unbanked and under-banked South Africans (Wood: 1999).

Access to credit allows financial leverage and financial leverage creates wealth (Levine, 1992). The emergence of the micro lending industry in South Africa can be ascribed to a 1992 amendment of the Usury Act that exempted loans of less than R6000 from its provisions. This was designed to open up the market for servicing small borrowers. The micro lenders began opening shops everywhere and the industry grew from nothing into a multibillion Rand industry between 1992 and 2000. Interest rates are typically a topical and emotional subject in the micro finance industry all over the world. The obvious and emotionally compelling arguments to highly subsidized credit to the worlds poor communities can be persuasive, particularly towards the cause of political expediency. Offering cheap credit can often win quick political points for those who champion such approach (AMEDP, 1996).

This paper tries to highlight the effects of the interest rate cap on the micro lending industry in South Africa. Improving access to credit for small enterprises and low-income individuals micro lenders will be through charging full-cost recovery interest rates. And the only way to achieve this is by removing price control from the Usury Act and allows the market forces to dictate prices freely.

2. Background

Micro lending is defined by the Micro Lending Association (MLA) as "the provision of credit to people who are unable to obtain loans or credit from commercial banks because their only security is the fact that they have regular source of income" (Thordsen and Nathan: 1999). The South African micro-lending industry is a rapidly growing market given the increased disposable income and accompanying need for credit in the emerging market in our economy. The highly sophisticated formal banking sector provides services to established businesses and middle to high-income individuals, but limits services to low-income individuals and micro-businesses almost entirely to the operation of savings accounts. This sector of the market is viewed by the formal Banks as high risk and insufficiently profitable because of the small size of the loans and concomitant proportionally high transaction costs.

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[1] The paper is largely based on a research report published recently by the Department of Trade and Industry on Interest Rates in the South African Microlending sector.

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The Usury Act (No.73 of 1968) is of immense significance for the micro finance market. It is intended to protect the borrower from exploitation and thus concentrates on consumer protection. The Department of Trade and Industry that is responsible for the Usury Act is subjected to heavy political pressure to ensure consumer protection (Staschen, 1999). Basically the Act imposes an interest rate ceiling on loan finance provided by money lending institutions. Given this, prior to 1992 it was not possible for micro lenders to charge full-cost recovery interest rates. Due to high administration costs as compared with traditional bank loans a Usury law clearly discriminates against micro lending.

Due to heavy political pressure on DTI and on the other hand resistance from micro finance experts, the Government on the 31 December 1992 issued a gazette notice (No.14498) of exemption from the Usury Act. The notice give exemption, (i.e. no interest rate ceilings) to money lending transaction on the condition they satisfied the following:

- Loans does not exceed R6000 and
- The term of the loan should not exceed 36 months

The exemption created a formal industry overnight. Micro lenders established businesses all over the country. On 30 June 1994 Minister of Trade and Industry announced that he was considering repealing the exemption (Government Gazette No 15836, 1994). On 1 June 1999 the Government issued a gazette notice (No.20145) of exemption from the Usury Act, which put to an end speculation and uncertainty surrounding the industry. The new exemption stipulated the following:

- A regulatory institution must be established to regulate the industry
- A micro lender must be registered with the regulatory institution
- The loan shall not exceed R10 000
- The loan term shall not exceed 36 months
- The interest rate shall not exceed ten times prime rate.

This prompted a court case between microlenders and the government. The judgment ruled in favour of government for all stipulations of the Gazette, except the setting of the interest rate at 10 times the prime rate.

3. Overview of the Market for Micro Lending in South Africa

There is no way to separate the supply side from the demand side of the industry; they must be looked at together. The demand functions can change as consumers become more sophisticated in the use of credit and as they understand the costs associated with borrowing or the benefits deriving from borrowing. The supply function can also evolve as the industry grows, becomes more sophisticated, develops new tools to lower costs associated with risk, develops new systems to lower administration costs and developing new ways of doing business (DTI, 2000).

There are many different types of individuals and companies involved in micro lending. Some are in the formal sector and many are in the informal sector. One of the prerequisites of entry into he industry is adequate seed capital. DTI (2000) differentiate the industry into three segments viz.:

- Formal registered firms, which include commercial banks, section 21 enterprise lenders, development lenders and short-term moneylenders.
- Semi-formal money lenders, which include small unregistered money lenders who are doing it as their main livelihood
- Purely informal money lenders such as township money lenders and stokvels

A wide range of firms has developed over the past 8 years to supply micro loans to the population in South Africa. The table below the table breaks out the formal lenders by legal category as they are registered with MFRC. The data does not include those institutions that have not been registered by the MFRC.

Type of Institution	Number of Registered Firms	Number of Certificates (outlets)	Outstanding Book (R)	Number of Debtors
Section 21	7	43	29,224,477	48214
Private Company	122	1960	1,202,456,352	558961
Closed Corporation	597	1025	191,864,981	270488
Bank	7	355	3,352,586,312	1389813
Public Company	8	284	302,465,465	224218
Trust	47	110	61,175,040	41164
Natural Person	58	72	8,874,228	16167
Mutual Bank	2	8	116,403,082	14604
Co-operative	4	16	66,010,133	31137
Total Registered	**852**	**3,873**	**5,331,060,133**	**2,594,766**

Source: MFRC data collected as of February 2000, quoted in DTI, 2000.

Why this massive demand for credit? "In the South African context access to financial credit is a rare commodity for the majority. A combination of factors, including the formal banking industry's shift away from the low income market, a growing gap between real income and inflation, increasing unemployment and irresponsible lending has fuelled demand and led to the growth of alternative financial service providers, most noticeably money lenders" (Black Sash Report: 1999). "Since many South Africans do not have access to the financial services offered by the sophisticated banking sector these institutions are instrumental in catering for various social and financial demand of the broader community" (Marais, 1999).

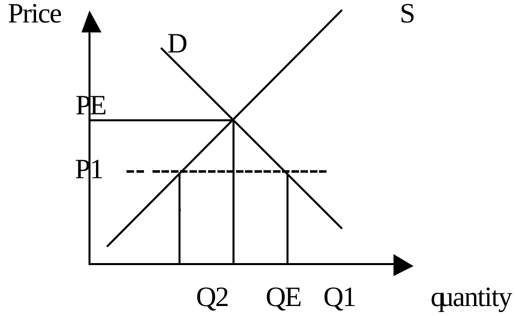
People borrower from micro lenders for a variety of reasons, including consumption borrowing to finance consumption and borrowing to finance a business. In general it can said that borrowers normally needs funds urgently, generally have no other financing options available to them, many are in a debt spiral and must keep turning their debt over (25 % of borrowers in a recent Northern Province survey), and do not think in terms of interest rate but in terms of the amount that must be repaid (cash flow considerations).

4. The Effects of an Interest Rate Cap on the Supply of loans

When the Government regulates the working of the market, supply and demand cannot interact freely to find the equilibrium quantity and price. When there is an artificial ceiling the allocation of resources is distorted if the equilibrium price is above the ceiling. The consequence is people who want finance, but due to their circumstances does not qualify at the ceiling interest rate are denied access. As this large segment of the market cannot access funds in the formal economy they have to resort to the informal economy. By limiting the interest rate chargeable the government may force many actors in this sector underground.

The Usuary Act ignores the fact that one of the reasons high interest rates are charged to these borrowers is that they are uneconomical to service at lower rates of interest (Aveyard, 1999). By placing a ceiling on the interest rate, but not providing an alternative means of finance, the government effectively excludes the people they were trying to protect. Let us consider the next diagram.

Figure 1. Effect of an interest rate cap on the supply of loans



Since interest rates are not allowed to rise above P1, there are no incentives to expand the quantity of loans offered and this will create a shortage. "Some suppliers may in fact leave the market altogether so that with the supply curve shifting inwards, the shortage will become even more acute" (Black et al, 1997). Basically the cap will encourage people to consume more of the service than if the market price were charged.

5. The Argument for Full-Cost Recovery Interest Rates

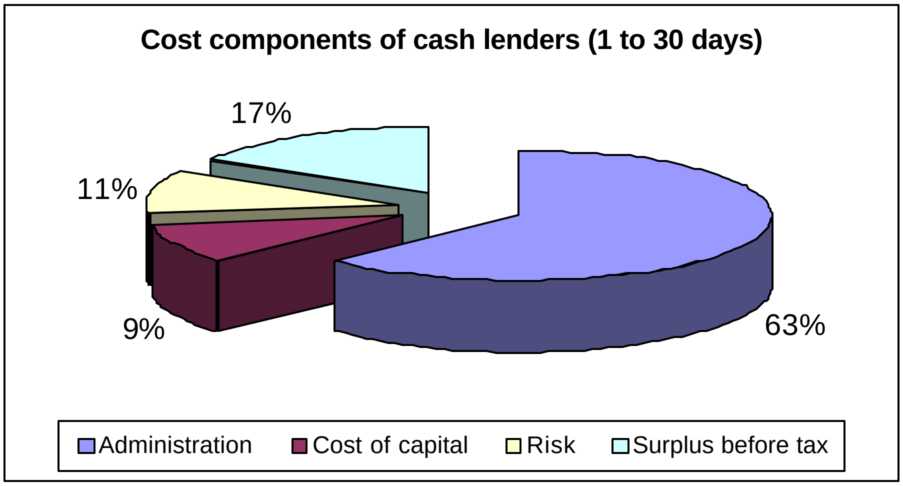
One of the key factors influencing the lack of supply of credit to small enterprises is the non-recoverability of costs. Charging a rate of interest on credit is the main source of income for many organizations in micro lending industry. It is the only way by which they can recover their costs – financial, operating and risk. The components of an interest rate in a small loan includes,

- Cost of capital
- Sufficient return to cover the risk of loan loss or bad debt
- Operating costs and
- A profit margin

Given these, the micro-lending institutions can only survive by fully recovering all the costs of the first three components, and grow if they can also receive the third component. These components were calculated based on information provided by the Micro Finance Regulatory Council (MFRC). The detailed information supplied by the MFRC and the financial statements of institutions also supplied by the MFRC were merged in one database reflecting a sample of 90 institutions drawn from the more than 800 registered institutions as at the end of February 2000. The financial statement information supplied to the MFRC during application for membership served as the basis for the calculations of cost components of these institutions. The information from financial statements were grouped into four categories, namely, administration costs, costs of capital, risks costs and surplus before tax.

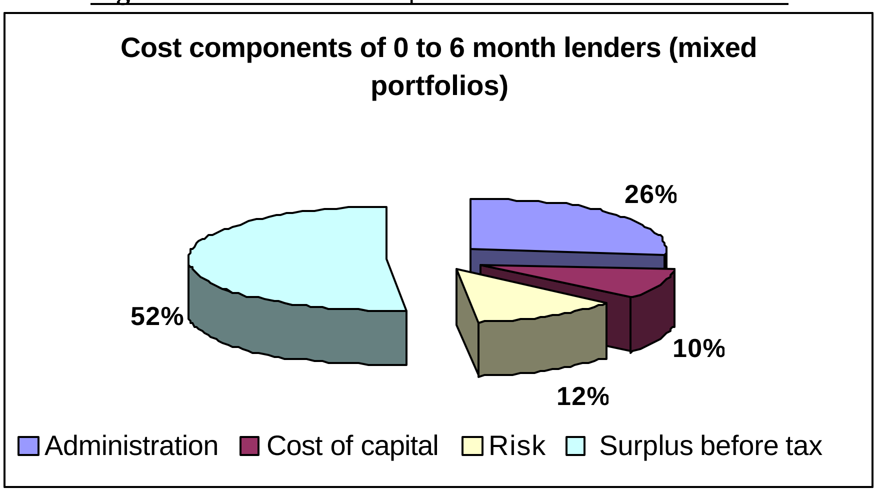
Figure 2 below depicts the cost components of cash lenders

Source: MRFC data as collected February 2000



From the figure above it can be observed that the bulk of the costs of cash lenders are administration costs.

Figure 3 indicates costs components of the 1 to 6 month lenders.



Source: MRFC data as collected February 2000

In this group the administration costs has decreased and the risk gone up. When studying the groups it is clear that cost of capital and risk cost are not as significant as administration cost of these institutions. Thus changes in prime rates or other standard measures of the cost of capital will have a negligible effect on the cost structure of micro lenders. Anything that increases administration costs would most definitely have an effect on these institutions and especially the smaller institutions, thus the cash lenders.

6. Revenues, Costs and Profits

The micro lending industry has been accused of charging exorbitant interest rates and making economic profits. Business Times (14/11/1999) "The interest rates charged by micro lenders are shameful". This section highlights the costs, revenues and profits that are experienced in the industry, providing a basis from which to gauge the attractiveness of the industry. To help understand the costs, revenues and profits of a micro lending business a simple example is provided. The estimates used were established through discussion with micro lenders. The example given is of a micro lender with a loan book of R527 282 and charging interest rates of 30, 20 and 10 percent per month.

	ACTUAL	PROJECTED	
	30%	20%	10%
LOAN BOOK	527282	527282	527282
INTEREST	158185	105456	52728
EXPENSES	63619	63619	63619
GROSS PROFIT	94566	41838	-10890
BAD DEBT	25000	25000	25000
PROFIT	69566	16838	-35890

As can be seen from example above when micro lender charges 30% per month on seed capital of R527 282 he can make profits, when the interest rate reduces he is losing.

7. Conclusion

The emergence of the micro lending industry in South Africa can be ascribed to a 1992 amendment of the Usury Act that exempted loans of less than R6000 from its provisions. This was designed to open up the market for servicing small borrowers. The micro lenders began opening shops everywhere and the industry grew from nothing into multibillion Rand industry. With the perception that the industry is exploiting the consumers and charges exorbitant interest rates, the Usury Act was passed. The law imposes interest rate ceilings on loan finance provided by micro lending institutions. This particular law has a negative effect on micro lenders, since they are not allowed to charge full-cost recovery interest rate most of them either close business or go underground. Therefore the consumers whom government tries to protect will be left without any option to finance and will resort to “loan sharks” who are not monitored and normally charge unscrupulous interest rates.

We believe that the interest rate ceiling would not in anyway induce micro lenders to innovate new ways of lowering administrative costs. The interest rate ceiling produces a series of adverse effects. They cause charges to drift up to the ceiling and they also encourage illegal lending. Instead of regulating interest rates a more effective approach to ensure that the rates charged by micro lenders are appropriate is to encourage competition. This will spur innovation aimed at reducing the risks and costs associated with micro lending.

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