

# Focus Note

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## COMPETITION AND MICROCREDIT INTEREST RATES

### Introduction

In many countries, including Uganda, Bangladesh, and Bolivia, microfinance has become more competitive in recent years.<sup>1</sup> Competition is generally expected to benefit consumers by offering a wider choice of appropriate products and providers, better service, and lower prices.

However, in some countries where microfinance is considered competitive, interest rates on microloans have remained stubbornly high. For example, in Bangladesh, interest rates on loans have averaged 15 percent flat for many years, despite competition among hundreds of microfinance institutions (MFIs).<sup>2</sup> This situation has been criticized by politicians and some activists and has even led to interventions, such as interest rate ceilings, to address the apparent failure of market-based solutions. In Bangladesh, for example, the state apex body PKSF recently capped on-lending interest rates for its MFI clients at 12.5 percent flat.

Does competition result in lower interest rates to microcredit customers? To address this question, this Focus Note analyses the experiences of Uganda, Bangladesh, and Bolivia.<sup>3</sup> These three countries are home to some of the early regional and even global pioneers of microcredit, such as Grameen Bank, CERUDEB, and PRODEM. Combined, they constitute a considerable mass of microfinance clients—nearly 12 million active borrowers, although Bangladesh has the most active borrowers by far (10.6 million compared with 500,000 in Uganda and 400,000 in Bolivia). Considerable primary and secondary research has already been undertaken in these countries in recent years—another factor in their selection for this study. In addition, none of these countries has a formal legislated interest rate cap. However, interest rate patterns in each have been different. Bolivia has seen sustained declines in microcredit interest rates over the past decade while, until recently, the interest rates in Uganda and Bangladesh have been flat, in nominal terms at least.

<sup>1</sup> A competitive market is one in which, (i) on the demand side, consumers have an effective choice of providers and the ability to distinguish among them and, (ii) on the supply side, providers need to take into account other providers' behavior when deciding the terms and conditions of the products and services they offer.

<sup>2</sup> "Flat" refers to an interest rate calculated throughout the life of the loan using the original loan amount, even though the borrower has progressively less of that amount still in her hands: 15% flat is equivalent to around 29% on an annual effective interest rate basis.

<sup>3</sup> This Focus Note is based on primary and secondary research in the three countries conducted by Iftekhar Hossain in Bangladesh, Gonzalo Paz in Bolivia, and Andrew Obara in Uganda. These researchers interviewed 20 leading microfinance managers in each country, and these perspectives are woven throughout this Focus Note.



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The different experiences of these countries suggest that lower interest rates are not the inevitable result of market development but are more likely to result when certain conditions are present: There must be sufficiently large providers in the market, with sufficient incentive and sufficient ability to reduce their rates.

This Focus Note will help microfinance institutions, policy makers, and donors assess the stage of development of competition in a particular market and determine whether appropriate conditions are in place to foster sustained interest rate reduction.

### What Are the Effects of Competition?

It is widely assumed that competition leads to lower prices because, in a market sector in which private firms make excess profits, new firms will enter and will seek to gain customers by offering lower prices than are offered by other firms in the market. Even if no new firms enter a market, the threat of entry should galvanize incumbent firms to offer competitive prices. Lowering prices, in turn, will reduce the excess profits of firms to a level where there is no further incentive to enter the market. Ongoing improvements in firm efficiency may nonetheless enable incumbent firms to compete against each other by further lowering prices over time.

This general expectation about competition's effect on pricing is qualified by the recognition that markets evolve and that the competitive behavior of firms will evolve as well. For example,

competitive behavior is likely to be quite different in a new, fast-growing market than in a mature, saturated market. A conventional view of market development outlines four distinct phases (see Table 1).

**Phase 1: Pioneer.** In the first phase of market development, a new product may be brought to market by one or, at most, a few providers, each with limited reach. Competition in this phase is limited to placing distribution points in new areas before others reach them.

**Phase 2: Take-off.** The visible success of early pioneers leads other firms to quickly enter into the market, and the market moves into the second phase. As volume and visibility of the product grow, firms compete primarily by improving products to better suit customers and by enhancing service levels. However, the market is still mainly supply driven. Incumbent firms are usually more willing to alter other aspects of their product than to reduce their price, and often they may not yet have the scale or cost structure they need to sustain lower prices. On the demand side, consumers may be unable to compare offerings in terms of price because products are not yet standardized.

**Phase 3: Consolidation.** As a result of rapid growth in the second phase, the market as a whole starts to show signs of saturation at the prevailing price level. Growth may start to slow, and the market enters a third phase. Growing the market, in this phase, usually means reducing prices to allow new consumers to

**Table 1 Competition through Market Development Phases**

Market characteristics	Market phases			
	1. Pioneer	2. Take-off	3. Consolidation	4. Mature
<b>Growth in volume</b>	May be slow	Rapid	Positive but slowing	Steady natural growth
<b>Number of firms</b>	One or a few	Increases rapidly	Reduces from peak because of consolidation	Depends on characteristics of product and market
<b>Market structure</b>	Concentrated	Fragmented, although market leader may emerge	Concentrating; clear market leaders emerge	Market leaders dominate
<b>Arenas of competition</b>	Little competition except as to location of distribution points	Product characteristics and service levels	Price	Brand (including pricing)

participate. By the time successful firms reach this phase, they have grown in scale and lowered their costs, leading to high profits that allow them to begin to reduce prices (in other words, they have the “headroom” to afford to lower prices). Prices initially will diverge more widely than before, and customers will begin to respond to the price signals. As prices fall, firms with higher cost structures may be forced out of the market. Competitive strategy changes from being supply driven, where suppliers compete to distribute their products, to becoming demand driven, where they are forced to respond more closely to clients’ needs.<sup>4</sup>

**Phase 4: Mature.** After the shakeout of firms with unsustainable, high cost structures, a mature market emerges, with a stable number of firms, and generally grows only as fast as external variables, such as demographics, allow. The firms now compete based on brand, which is the composite embodiment of the customer experience with the service, including all the traditional features of price, place, and product. Average prices may drop further if greater efficiencies are obtained through economies of scale. However, price differentials between firms may widen, because effective branding may enable premium pricing even for an otherwise similar product.

The mature phase is not the end of the story for most markets. Even after reaching maturity, as defined here, technological and business model innovations may upset the prevailing market structure by introducing new competitive behavior, causing the cycle to repeat.

This simplified description of market development highlights the fact that competition is present throughout a firm’s existence: The competitive behavior of firms changes in response to customer needs and other firms’ actions. The benefits of competition are not limited to pricing. Customers also value greater access, better products, and enhanced service. Substantial price competition would not be expected until the third phase, as the market begins to consolidate.

Several researchers have applied versions of this market-phase approach to microfinance markets.

From her study of competition in a localized market in Kenya, Johnson suggests that the basis of competition moves first from availability of the service, to enhanced customer service, and then finally to price.<sup>5</sup> Portocarrero and Byrne propose a version in which new entry and increasing market saturation ultimately fuel competitive price cuts.<sup>6</sup> In Rhyne’s two-stage analysis, there is a “pre-competitive” phase, in which the main driver for MFIs is to raise funds for rapid growth, followed by a competitive stage.<sup>7</sup> In the second stage, attracting and retaining clients to support market share is the dominant consideration. These studies support the notion that price competition in microfinance generally follows other competitive strategies.

But the microcredit market, in particular, has several features that may limit or change the nature of competition and its expected outcomes. The conventional approach assumes competition among profit-maximizing firms. However, non-governmental organizations (NGOs) that do not seek to maximize profit have been dominant, or at least important, players in many microcredit markets. Furthermore, in some markets, donors and government-controlled wholesale funders have influenced lender behavior through their control of funds. For example, when external funders impose restraints on pricing, microlenders are no longer free to make fully competitive pricing decisions. Group-based lending approaches can also make it more difficult for individual consumers to switch providers (even though consumers can and do join multiple groups).<sup>8</sup> The presence of some or all of

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<sup>4</sup> Wright and Rippey, “The Competitive Environment in Uganda: Implications for Microfinance Institutions and Their Clients,” MicroSave, September 2003.

<sup>5</sup> Johnson, S. “The dynamics of competition in Karatina’s financial markets.” Imp-Act Working Paper No. 9. Institute of Development Studies, 2003.

<sup>6</sup> Portocarrero, F., and G. Byrne. “Estructura de Mercado y Competencia en el Microcredito.” CIES Paper, July 2003.

<sup>7</sup> Rhyne, E. *Mainstreaming Microfinance*. Kumarian Press, 2001.

<sup>8</sup> Even with the continued dominance of group-based lending in Bangladesh, where costs of leaving an established group are high, there is rising evidence of multiple borrowing (Zohir). In Uganda, borrowers participate in several groups simultaneously to reduce their dependency on any one group and to increase their borrowing power (Wright and Rippey, 2003).

these factors in particular microfinance markets is likely to change the dynamics and outcomes of competition from what the theory may predict.

## Background on the Three Microcredit Markets<sup>9</sup>

The microcredit markets in Uganda, Bangladesh, and Bolivia have both similarities and differences (see Table 2). Uganda occupies the middle ground of the three countries. In Uganda, a large number of relatively smaller MFIs deliver microloans. Not-for-profit providers control half the loan book, and half the loan book is group based.

Bangladesh is a highly populous, predominantly rural and poor country. In Bangladesh, hundreds of mostly nonprofit providers offer very small loans, commonly using group-based methodologies.<sup>10</sup>

Bolivia, on the other hand, is the wealthiest, least populous, and most urban country in the

sample. Its financial sector is better developed than that of Uganda and Bangladesh. Microcredit in Bolivia is delivered by fewer, more commercial providers that offer loans, usually to individuals (as opposed to working with groups).

## Competitive Strategies

The microcredit markets of Uganda, Bangladesh, and Bolivia are considered among the most competitive in the world. Country-level surveys used as

<sup>9</sup> The focus of this study is microcredit only, rather than microfinance generally, which would include other distinct product markets, such as savings or micro-insurance. “Microcredit” as used here is defined as credit to self-employed people for the short to medium run (up to 18 months). Of course, products are often tied across markets—for example, savings or insurance as a requirement for credit—and even to nonmarket services, such as health care or business services. However, narrowing the focus was necessary to draw clearer conclusions and make the study more tractable.

<sup>10</sup> Some commentators stated that group lending continues in name only in Bangladesh today, and that *de facto* individual lending is the norm.

**Table 2 Microcredit Markets in Uganda, Bangladesh, and Bolivia, 2003**

	Uganda	Bangladesh	Bolivia
Total population <sup>a</sup>	25.3m	138.1m	8.98m
GNI per capita (PPP basis) <sup>b</sup>	\$1,360	\$2,770	\$2,390
Financial depth (M3/GDP) <sup>c</sup>	20.8%	40.2%	52.3%
Rural population <sup>d</sup>	87.7%	75.7%	36.6%
Population living on less than \$2 per day <sup>e</sup>	44%	82%	34%
Active borrowers <sup>f</sup>	500,000	10,600,000	400,000
Average loan size outstanding <sup>f</sup>	\$256	\$67	\$1000
Average loan size to GDP per capita <sup>g</sup>	104%	18%	112%
No. of providers <sup>f, h</sup>	102	721	21
Total value of microcredit (2003) <sup>f</sup>	\$114m	\$905m	\$318m
Average loan book size per provider <sup>f</sup>	\$5.2m <sup>i</sup>	\$1.3m	\$25m
Loan book by nonprofit entities <sup>f, h</sup>	50%	69%	19%
Loan book group-based loans <sup>f</sup>	46%	100% <sup>j</sup>	30%

**Notes:**

<sup>a</sup> World Bank via [devdata.worldbank.org/external/CPProfile.asp](http://devdata.worldbank.org/external/CPProfile.asp)

<sup>b</sup> UN Habitat statistics via [www.prb.org/datafind/prjprbdata/wcprbdata5.asp](http://www.prb.org/datafind/prjprbdata/wcprbdata5.asp)

<sup>c</sup> Financial depth: IMF International Financial Statistics via [www.imf.org/external/pubs/cat/longres.cfm?sk=397.0](http://www.imf.org/external/pubs/cat/longres.cfm?sk=397.0)

<sup>d</sup> UN Habitat statistics via [www.prb.org/datafind/prjprbdata/wcprbdata5.asp](http://www.prb.org/datafind/prjprbdata/wcprbdata5.asp)

<sup>e</sup> UN HDR 2003; Uganda: percent in poverty by official definition, 2001

<sup>f</sup> CGAP country reports

<sup>g</sup> Calculated from The MIX Market country profile and average size in row 6 (Active borrowers)

<sup>h</sup> Number of providers: Bangladesh = as reported by CDF plus Grameen Bank; Uganda = a 2002 estimate of formal and informal microlenders of all types, including SACCOs, was 1500, however, to achieve some comparability, the number used here is the number of members of the industry body, AMFIU, as a proxy for a comparably formal group; Bolivia = members of associations Asofin and Finrural, which constitute the bulk of the market and are used as the basis for other numbers in this table and elsewhere in this Note.

<sup>i</sup> Average of the 11 Uganda MFIs reporting to The MIX, which includes the largest players

<sup>j</sup> See footnote 10 on this categorization of group-based credit.

background for the analysis presented here confirm that local MFIs describe their markets as competitive. A range of large and small providers deliver relatively similar microcredit products. Moreover, the providers pay close attention to each other's actions. All MFIs interviewed indicated that they regularly assemble competitive intelligence about each other's product offerings; the process is least formal in Bangladesh. This intelligence affects their product design and, in some cases, their pricing decisions. The interviews further show that competitive tactics widely used include the following:

- Competitive locations—opening new branches in underserved areas
- Flexible product terms—making loan terms more flexible, for example, by allowing longer, larger loan amounts for first and subsequent loans
- Product add-ons—introducing other loan types, such as housing, or other financial services, such as savings or insurance linked to the loan
- Improved service—reducing the time from application to disbursement of loan

Providers in all three countries said that competition had intensified in the past three years and that the trend was likely to continue.

Microcredit interest rates are set in different ways in the three countries. The rate-setting processes are formal in the larger Ugandan and Bolivian MFIs. Asset and liability committees typically review rates semi-annually or more often, looking at market funding rates, costs, and competition. The process appears less formal in Bangladesh, where the flat and homogenous rate structure has made the price-setting function much less relevant until recently. In general, the larger Bangladeshi MFIs make pricing decisions based on their own viability and their need to fund growth. Smaller MFIs historically have been price takers in that they have followed the pricing of larger entities, rather than setting their interest rates independently.

Microloan books continue to grow rapidly in all three countries. In each market, the value of recorded microloans outstanding grew by roughly 15 percent a year between 2001 and 2003. This

outpaced the growth in total bank credit in each country over the same period. As a result, although the value of microcredit remains small in relation to total bank credit in each country, its share is growing in all three countries.

Where do Uganda, Bangladesh, and Bolivia fall in the evolution of competition, and more specifically, how is competition affecting interest rates in these countries?

## Uganda: Approaching Consolidation

The Ugandan microfinance sector in 2003 is best described as near the end of its take-off phase in market development. It is still growing rapidly, has the lowest market penetration of the three countries, contains a relatively large number of small MFIs, and still has new firms entering the market.

According to one study, there were an estimated 1,500 microlenders in Uganda in 2002, although most were small and informal.<sup>11</sup> The Association of Microfinance Institutions of Uganda reports 102 formal lenders of varying sizes.

The largest single microlender in terms of portfolio size (but not number of clients) is Centenary Rural Development Bank (CERUDEB). CERUDEB's predecessor NGO was established in the 1980s to promote financial services in rural Uganda. The bank was licensed in 1993. Today, CERUDEB is a commercial bank that offers credit and a range of other services to low-income people. It has almost 50,000 microborrowers and a loan book of \$44 million.

To support the growth of the sector, Uganda passed the Microfinance Deposit Taking Institutions (MDI) Act in 2003. This law allows larger MFIs to take savings under central bank supervision, thus enhancing their viability while safeguarding deposits. So far, only four institutions have applied and qualified for the program. Most MFIs are likely to remain unregulated. Discussions about regulating the numerous smaller so called fourth-tier MFIs have

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<sup>11</sup> Goren, Ruth Goodwin, Till Bruet, and Alexia Latortue, "Uganda Microfinance Sector Effectiveness Review," CGAP, 2004.

not progressed far. Together with CERUDEB, the three largest MDIs control nearly 60 percent of the market, and concentration is growing.

The microfinance sector serves an estimated 500,000 active borrowers, with outstanding loan balances of around \$128 million in 2004. These borrowers are found across urban, peri-urban, and rural areas, although coverage is low in certain rural areas. More than 70 percent of MFI clients in Uganda are women.

*The Effect on Interest Rates.* Nominal interest rates declared by Ugandan MFIs have declined little in recent years. Weighted for the size of MFIs, the market average declined somewhat in 2002 following a one-off adjustment by CERUDEB that reflected bank funding rates. There has been little change since then, as Figure 1 shows. However, the differential between microcredit and commercial bank interest rates shows that, relative to commercial bank credit, microcredit has become about 10 percent less expensive between 1999 and 2004.

All Ugandan MFIs interviewed expect substantial reduction in microcredit rates over the next five years, from an average effective rate of around 50 percent today to below 40 percent. According to the predictions of some market participants, the average could drop below 30 percent.

## Bangladesh: Consolidating

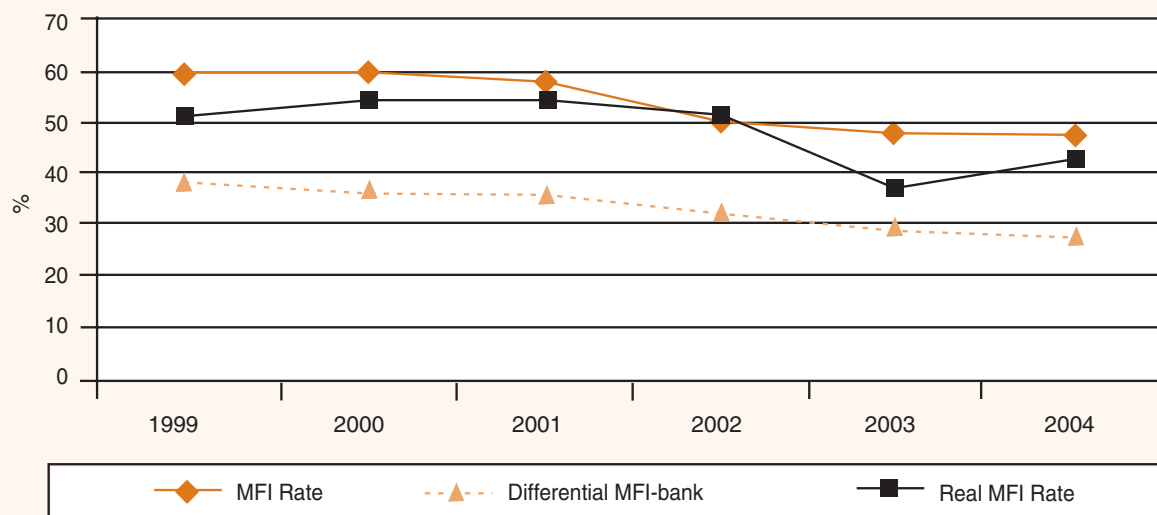
The microcredit sector in Bangladesh continues to grow rapidly and has a large number of providers. However, the top four MFIs provide the bulk of microloans. Grameen Bank, the microfinance pioneer, had more than 3 million active members in 2003.<sup>12</sup> Other major MFIs have emerged in the past 30 years, including BRAC (4 million members), ASA (2.3 million), and Proshika (2.8 million). The four largest MFIs together constitute almost 70 percent of microborrowers in the country today.

Industry statistics compiled by the the Credit and Development Forum (CDF) show that the number of MFIs rose from 533 in 1999 to 721 in 2003.<sup>13</sup> However, this increase is thought to reflect more comprehensive reporting rather than the formation of new MFIs. MFIs are still mainly NGOs, even though some large government programs and a few banks, such as Islami Banking Corporation, are active in retail microlending. Other banks provide wholesale loans to MFIs.

<sup>12</sup> Not all members of Bangladeshi MFIs are borrowers at any one time; some are savers only.

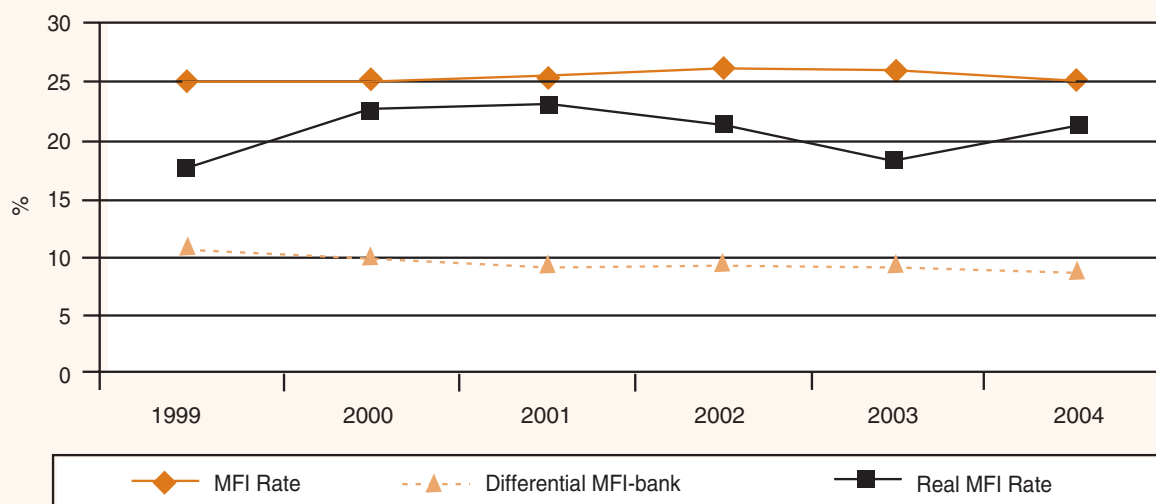
<sup>13</sup> CDF is a national network of Bangladeshi NGO MFIs.

Figure 1 Ugandan Interest Rates



Sources: MFI rates: Country study; Inflation and banking lending rates: IMF International Financial Statistics, [www.imfstatistics.org/imf/logon.aspx](http://www.imfstatistics.org/imf/logon.aspx)

Figure 2 Bangladesh Interest Rates



Sources: MFI rates: Country study; Inflation and Banking lending rates: IMF International Financial Statistics,

The number of active microfinance members at the end of 2003 was 13.5 million, nearly three times the 4.9 million reported seven years before. Ninety percent of MFI members live in rural Bangladesh, and 85 percent are women.

*The Effect on Interest Rates.* To date, there is no law in Bangladesh that limits interest rates. Figure 2 shows that nominal rates have been constant for much of the past five years, although changes in inflation have affected real (i.e., inflation-adjusted) rates. The weighted average of around 25 percent is derived from the rates charged by Grameen Bank (10 percent flat equivalent to 19 percent as an annual effective rate) and most other MFIs (15 percent flat or 29 percent annual effective). The differential between microcredit rates and average commercial bank rates quoted in IMF's International Financial Statistics has also remained relatively flat.

Although microloan interest rates in Bangladesh are relatively low by international standards, political pressure to reduce rates has been increasing.<sup>14</sup> In April 2004, the state-backed apex or wholesale funder of microfinance, PKSF, publicly voiced concerns about poor borrowers having to pay for inefficient MFI operations. PKSF's research into

the cost structure of its partner organizations concluded that inefficiencies were keeping the cost structure of microcredit high.<sup>15</sup> PKSF capped the on-lending rate of all its clients at 12.5 percent flat (approximately 24 percent annual effective rate) beginning in January 2005.<sup>16</sup> PKSF clients agreed to the new ceiling with the exception of the two largest, ASA and BRAC, which together constituted almost two-thirds of PKSF's loan portfolio.

The result is a three-level interest rate structure for microcredit in Bangladesh. Grameen Bank, with 18 percent of the market, has the lowest rate at 10 percent flat. PKSF partners, with a total market share just under half, are pricing at 12.5 percent. ASA and BRAC, with a third of the market, remain at 15 percent.

Average microcredit interest rates have therefore declined recently, but this has been the result of external pressure from PKSF more than competition

<sup>14</sup> A median international gross yield of 34 percent was reported by the *MicroBanking Bulletin* as the 2003 benchmark across all reporting MFIs, [www.mixmbb.org/en/benchmarks/2003/2003%20MFI%20Benchmarks.xls](http://www.mixmbb.org/en/benchmarks/2003/2003%20MFI%20Benchmarks.xls).

<sup>15</sup> Uddin, J. "Current Interest Rate and Financial Sustainability of PKSF's Partner Organizations." PKSF, December 2003.

<sup>16</sup> As of December 2003, borrowings from PKSF financed just over one-fifth the total loans outstanding of all MFIs reporting to CDF.

within the market. Some observers assert that PKSF's rate peg discourages competition by limiting returns and making it harder for new entrants that lack the economies of scale necessary to survive within the ceiling. PKSF argues that it is laying the basis for sustainable ongoing reductions in rates by forcing greater efficiency in the sector.

Some efficiency gains will come through consolidation into larger size MFIs. The nature of consolidation in an environment of NGO-provided group-based microcredit is likely to differ from the standard market one, where entities merge or successful firms buy failed ones.<sup>17</sup> An NGO cannot be bought, although its loan book may. However, in a group-based loan environment with high personal interaction with the loan officer, it is not clear that the loan books can be taken over in the usual way. More likely, the result would be MFI failures, which could reduce the number of providers substantially. This would be expected in the consolidation stage of a market. The remaining lenders may be larger and more efficient, but this does not guarantee that the benefits will be passed through to customers in terms of lower rates. Large Bangladeshi MFIs interviewed for this analysis do not expect microcredit interest rates to change much in the next five years.

Microfinance in Bangladesh faces additional possible changes. For one, the threat of more general rate caps from the central bank looms over the Bangladeshi market. In addition, a law has been drafted creating a new legal form—a microcredit bank—that would enable for-profit lenders to enter the market and take deposits. The passage of this law could create new sources of future price competition.

### **Bolivia: Ending Consolidation, Entering Maturity**

Bolivian microfinance was born during a mid-1980s wave of macroeconomic reforms, including the closure of state development banks. In 1987, prominent Bolivian businesspeople and politicians together with the microfinance network ACCION International started PRODEM, one of the first modern MFIs, with funding from the U.S. Agency

for International Development. PRODEM used a small group lending methodology to serve micro-entrepreneurs. By 1991, PRODEM had a loan portfolio of \$5 million and was growing fast. To expand options for funding this growth, PRODEM became the first NGO to form a regulated micro-finance bank, BancoSol, in 1992.

In the same year, Procredito was launched by the international consulting group IPC using an individual lending approach. Procredito also grew rapidly. In 1995 Bolivia created a new regulatory window, Fondos Financieros Privados (FFPs), under which MFIs could be licensed to take deposits with lower minimum capital than banks. Procredito received an FFP license as Caja los Andes and has since obtained a full banking license.

By 1997, about 50 percent of eligible micro-entrepreneurs had accessed microcredit.<sup>18</sup> At the same time, several commercial consumer credit companies started up, the largest of which was the Chilean firm Acceso. These companies lent aggressively to salaried workers and eventually also to microentrepreneurs, thus entering the market of traditional MFIs. But they did not properly appraise the microentrepreneurs' repayment capacity. Clients increasingly took on multiple loans. By one estimate, close to a third of FFP clients were indebted to more than one lender at this time. The intensity of competition grew. "During the late 1990s, interest rates dropped and clients began paying attention to small differences in rates from one lender to the next."<sup>19</sup>

Rising over-indebtedness, combined with an economic downturn, led to a surge in delinquency in 1999–2000 that bankrupted consumer lenders and hurt traditional MFIs. In a climate of crisis, a disaffected debtors' movement was formed, and street protests occurred at lenders' offices. This crisis is regarded as the "coming of age" for the major Bolivian MFIs, all of which survived. As a result of the crisis, fewer, larger, and more stable MFIs remain. Bolivian microcredit has apparently passed

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<sup>17</sup> Comment by David Wright, personal correspondence with author.

<sup>18</sup> Rhyne, 2001, p. 123.

<sup>19</sup> *Ibid.*, p. 154

into the mature phase, but growth continues to be higher than would be expected during this phase.

Today, seven regulated microcredit providers and 14 unregulated institutions make up the bulk of the microcredit sector in Bolivia. In addition, there are dozens of small local financial cooperatives and NGOs. The credit bureau Infocred estimates that there are more than 400,000 active microloan clients with aggregate outstanding loan balances of \$500 million. The four leading MFIs (Banco Sol, PRODEM, Banco Los Andes Procedito, and FIE) are regulated and hold 71 percent of loan value.

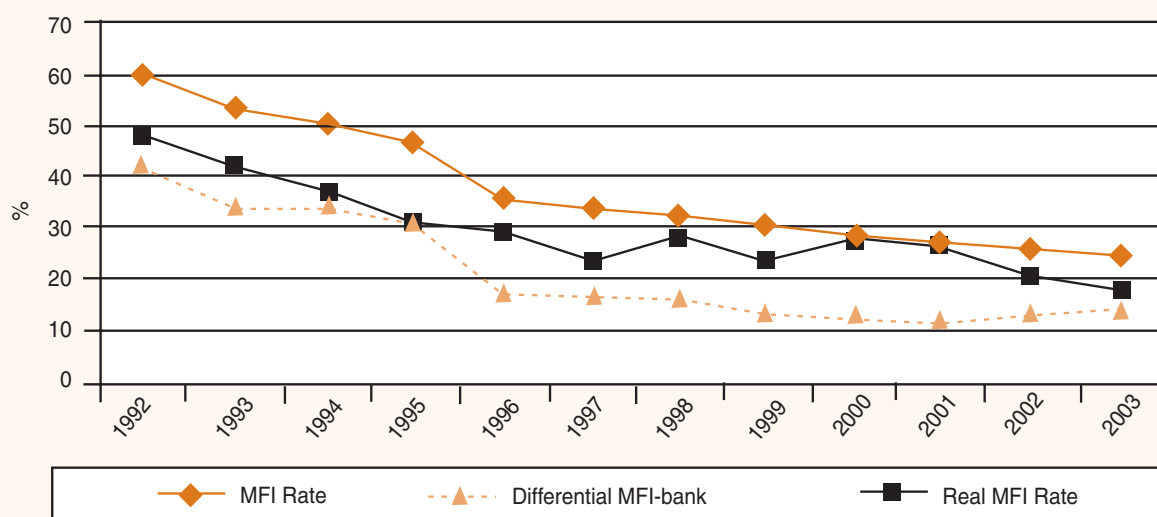
*The Effect on Interest Rates.* Figure 3 shows that there have been successive interest rate reductions by leading Bolivian MFIs in both nominal and real terms: average yields dropped from 50 percent in the mid-1990s to an average of just over 20 percent today. The differential between MFI and bank lending rates has remained more or less constant since the mid-1990s. The rate reductions came earlier than expected: the most dramatic reductions came between 1992 and 1998, before the onset of consolidation in 1999.

Decision makers in the major Bolivian MFIs were asked why rate reduction began so early in Bolivia. They cited several factors:

- Competition among lending methodologies, featuring the rapid growth of individual lending (led by FIE and Los Andes), forced MFIs using group-based loans (such as Banco Sol and PRODEM) to reduce their interest rates.
- The creation in 1994 of FFPs allowed MFIs to take deposits, reduce their cost of funding, and provide liquidity for faster growth. This new legal structure helped create headroom for rate reductions.
- Lower rates for subsequent loans also pulled interest rates down as more borrowers repeated loan cycles.
- MFIs that charged less tended to grow faster on average, reducing the weighted market average.

Although price was not considered a dominant competitive strategy in Bolivia in the 1990s, it was a defensive strategy to stop customer attrition. Borrowers apparently noticed the early rate reductions at the time and were even pleased by them, but lower price in itself was not a priority for them. According to MFI managers, the main customer priority was, and remains, the size and type of loan and time to receive it. Nonetheless, Bolivian MFIs expect a continuing gradual decline in average rates over the next five years, from a market average of 21.7 percent for regulated entities to 17–20 percent.

**Figure 3 Bolivian Interest Rates**



Source: MFI rate: Gonzales-Vega and Villafarni (2004), Graph 55; CPI inflation and bank rates: IFS

Some observers assert that the increasing profitability and growth in loan books were caused mainly by lenders increasing their loan sizes and, in effect, abandoning poorer customers who can afford only small loans. The evidence here is mixed: the average loan size of what Gonzalez-Vega and Ibarnegaray call “traditional regulated MFIs” (which constitute the bulk of the market) increased relatively little between 1995 and 2004, from just below \$1,500 to just above \$1,500.<sup>20</sup> However, the average loan size of the remaining FFPs rose considerably, from around \$600 to around \$3,750, over the same period. More important, the proportion of small loans (under \$1,000) in the total lending of regulated MFIs has not changed much over the decade.<sup>21</sup> Increased competition has not necessarily forced lenders up-market in Bolivia.

### When Does Competition Lead to Interest Rate Decline?

The foregoing analysis suggests that the three markets are at different stages of competitive development, summarized in Table 3. One would therefore expect differences in the nature and outcomes of competition, especially on interest rates. Uganda shows clear signs that it is entering an era of rate competition that will lead to rate decline. Although Bangladesh is entering a consolidation phase as the market becomes more saturated, “the price war is indefinitely delayed” as one analyst put it.<sup>22</sup> Bolivia,

on the other hand, has seen sustained price declines that started early.

The experiences in Bangladesh suggest that it is not inevitable that price competition will emerge as markets develop—or at least, that it can be significantly delayed in market development. The particular history of microfinance in Bangladesh helps explain this. Unlike Bolivia where different types of microlending (group versus individual) competed early on, Bangladesh has had one dominant approach to microcredit, so that competition has been based mainly on particular features of the loan product and service.

The strong poverty alleviation focus of the major Bangladeshi MFIs also ensured that initial microlending rates were relatively low by international standards, so there was not much headroom for rate reductions until more recently.

Furthermore, the dominant NGO microfinance providers in Bangladesh place a premium on the extent and depth of outreach to poor borrowers, exemplified in the very low average loan size to GDP ratio in Table 2, rather than on conventional profit seeking, as commercial providers would. This focus makes it less likely that they would strongly pursue competitive pricing strategies. Ironically, the greatest strength of the Bangladeshi microcredit

<sup>20</sup> Gonzalez-Vega, C., and M. Villafani Ibarnegaray, *Las Microfinanzas en el Desarrollo del Sistema Financiero de Bolivia*, Proyecto Premier, 2004, Graph 21.

<sup>21</sup> *Ibid.*, Graph 25.

<sup>22</sup> Hossein, I., “Competition and Efficiency in Microfinance: Bangladesh,” Unpublished country study, CGAP, 2005, p. 11.

**Table 3 Summary of Features of Competition**

	Uganda	Bangladesh	Bolivia
<b>Growth in volume</b>	Very rapid	Still rapid	Still rapid
<b>Number of firms</b>	Large, with entry of new players and exit of smaller MFIs	Large, but likely to reduce	Small, stable
<b>Market structure</b>	Largest 4 control over half the outstanding loans, consolidation is growing	Largest 4 dominant with 69% market share	Largest 4 dominant with 71%; top 10 control 90% of market
<b>Interest rate patterns</b>	Relatively flat in nominal terms, but declining relative to bank lending rates	Flat, although structure splitting into three ranges	Still reducing in nominal terms, after large reductions in 1995–2000, but stable in relation to bank rates
<b>Competitive phase</b>	Late take off (Phase 2)	Early consolidation (Phase 3)	Late consolidation (Phase 3) to early maturity (Phase 4)

sector—its depth and scale of outreach—may impair its desire to respond to potential price incentives.

The lack of competitive price pressure is compensated by externally imposed caps from PKSF and pressure from politicians. PKSF price caps have introduced a dynamic into the market that will be worth monitoring: Will the lower rates at PKSF-funded MFIs cause them to attract more clients, thus spurring generalized price competition? Or will it simply force less efficient MFIs out of business, without passing through to clients the price benefits of greater efficiency? Indeed, the market position of the large MFIs that are not bound by the caps today could be merely strengthened as a result. The Bangladesh case suggests that, as access to microcredit broadens in a country, pressures on interest rates grow—if not from clients directly, then indirectly through regulators and policy makers.

In the face of these pressures, can the process of competitive rate reduction be deferred indefinitely as a market develops? The experiences of the microcredit sector in the three countries studied suggest that certain conditions need to be in place for a sustainable reduction in interest rates. These conditions apply to both the supply and demand sides of the market. Firms must be able to sustain lower rates while also believing that their clients or potential clients will respond positively to these lower rates.

*Demand Side: Consumer Preferences, Awareness, and Behavior.* In competitive markets, the behavior of firms is ultimately driven by consumer preferences. Do microborrowers understand and want lower interest rates, relative to other choice factors?

The foundation of modern microcredit is built on the belief that poor clients are so starved for credit that their main concern is access rather than interest rates. Interviews conducted with MFI managers in all three countries confirm a prevailing view that price is a low priority for clients, relative to product-related factors (such as loan size) and service-related factors (such as time to disbursement or time spent at group meetings). To illustrate this, one major Bangladeshi MFI reported

that it suffers no competitive disadvantage by maintaining its higher rate when others were recently forced by PKSF to reduce theirs. They retain clients simply by offering a better quality of service.

However, mounting evidence indicates that price is beginning to matter more now to microborrowers, even if it did not matter before. According to MicroSave's extensive client surveys and focus groups in Uganda, "clients have repeatedly cited interest rates as one of the top determinants of their choice of the financial service provider from whom they borrow." Even in Bangladesh, where the market appears to be the least price-sensitive, clients are aware of price as a comparative factor. A commonly heard statement is "you join Grameen for big loans and *cheap* housing loans, ASA if you need money quickly, and BRAC for education and health services in addition to the financial service."<sup>23</sup>

Although clients are aware of price, few appear to act on it. Wright and Rippey report that "... only 11 percent of the sub-sample of those currently borrowing had shopped around multiple institutions prior to taking their loans."<sup>24</sup> Two factors may account for this gap between awareness and action.

First, borrowers see a distinction between the interest rate and effective "price" of a loan, which they experience as the installment due for a given loan amount.<sup>25</sup> Comparing interest rates (flat versus effective, compounding monthly versus annually, and so on) requires borrowers to have levels of financial literacy that do not exist widely even in some developed countries. In some circumstances, lenders compound the problem by complicating their pricing so as to make comparison difficult. As a result, the borrower can compare only installment

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<sup>23</sup> Italics by author; quoted in CGAP country report.

<sup>24</sup> Wright and Rippey, 2003.

<sup>25</sup> A 2004 nationwide survey in South Africa (FinScope 2004) found that, of those who report being regular borrowers (roughly half), "an affordable monthly installment" was by far the most significant factor in choosing a credit provider, cited by 36%. Interest rates were a distant second at 17%, although the two are clearly related. However, among unbanked people (more likely to use microcredit as defined here), interest rates dropped to third place (only 12% cited it) behind repayment terms (22%). The same survey also indicated widespread ignorance of the concept of rates in general (such as the inflation rate).

sizes on loans of similar amount and duration, which often is not practical.

Improving consumer financial literacy prepares the ground for price competition. Standardized disclosure of interest rates would further facilitate easier and fairer price comparison. Various initiatives in Uganda promote consumer financial education.<sup>26</sup> The Bank of Uganda also publishes a table of bank product charges on its Web site to enable easy price comparison (however, this service does not yet extend to microcredit).<sup>27</sup>

Even if a borrower can understand and compare the interest rate structure, the real cost of a loan is more than the interest rate alone. It includes the opportunity cost of time and travel to obtain and service the loan. The difference between the declared interest rate and the all-in consumer cost may be substantial. For example, although individual loans may carry a higher interest rate than group loans, the time saved by a busy borrower through avoiding group meetings may still make the individual loan “cheaper.” Hudson comments that in Uganda, “Clients feel that the prices they are paying for loans are high, but they are unable or unwilling to search for the best deals.”<sup>28</sup> The search costs, not captured in the declared rate, may simply exceed the benefits of finding a reduced rate elsewhere. As a result, consumers are less responsive to decreases in the rate by itself. For instance, in Bolivia, it was the combination of the time-saving individual lending methodology with lower interest rates that created a highly competitive proposition and forced defensive rate reductions by group-based lenders and, ultimately, a transition to the individual lending methodology.

The bottom line is that interest rates may, in fact, matter to clients (at least implicitly through the installment), but not enough to cause existing clients to swap providers or even shop around. Nor does it cause new clients to enter the market for the first time. MFIs would experience this as no or low price elasticity of demand for credit. Price elasticity of demand is difficult to test empirically because it requires carefully controlled price experiments. However, it can be done. Two studies

use large recent datasets of microborrowers in South Africa and Bangladesh.<sup>29</sup> Both studies find some evidence of price elasticity—lower rates will increase loan demand, and higher rates will reduce demand—although demand becomes price sensitive only at higher-than-normal rates.

Awareness of and sensitivity to interest rates is likely to increase over time as microfinance clients become more experienced, sophisticated borrowers—a dynamic that is already apparent in Bolivia. Likewise, interest rate sensitivity is likely to increase as clients become more literate and educated. The success of microfinance creates disciplined, better-off clients who are more attractive to a range of lenders. The emergence of these borrowers will likely increase client price sensitivity. Although MFIs in the three countries observe and assume low price sensitivity among their clients today, these underlying shifts mean MFIs will need to pay more attention to their pricing in the future.

***Supply Side: The Role of Market Concentration and Headroom.*** Demand-side factors tend to exert a pull toward greater interest rate competition over time. When firms come to believe that clients will respond to price incentives, they are motivated to at least consider reducing rates. However, pricing competition alone does not mean that overall market interest rates will necessarily decline over time. Interest rate cuts among a few small providers will not affect overall market patterns. And if rate-cutters cannot sustain the reductions, the effect will be limited, rather than generating a continuing trend as witnessed in Bolivia.

Portocarrero and Byrne’s study of Peruvian microfinance shows that some measure of market concentration is necessary for rate competition to emerge.<sup>30</sup> In other words, there must be a market

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<sup>26</sup> *Deepening*, the eNewsletter of the FSDU No. 3, March 2005.

<sup>27</sup> See [www.bou.or.ug/commbank\\_070305.htm](http://www.bou.or.ug/commbank_070305.htm).

<sup>28</sup> Hudson, R., “An In-Depth Qualitative Assessment of the Ugandan Micro-finance Environment,” 2003.

<sup>29</sup> Karlan, D., and J. Zinman, “Demand Curves for Consumer Credit: Evidence from a Randomized Field Experiment,” Unpublished paper, MIT Poverty Action Lab, 8 September 2005. Dehejia, R., H. Montgomery, and J. Morduch, “Do Interest Rates Matter? Credit Demand in the Dhaka Slums,” Unpublished paper, 9 March 2005.

<sup>30</sup> Portocarrero and Byrne, 2003.

leader or leaders sufficiently large to influence the overall pattern of rates by effectively forcing others to follow its price changes. In a fragmented market structure (such as certain Peruvian regional markets in their study), no one provider will have this influence. Bolivian microcredit had clear market leaders from the outset, and the structure has become more concentrated over time. In Uganda, where price reductions are likely to start, market structure is also concentrating around a small number of fast growing market leaders. Bangladesh demonstrates the exception to this rule; although it also has a concentrated market, interest rates have not come down.

If providers compete by lowering interest rates, they must be able to sustain the reduction in revenue that results. In Bolivia, rates dropped only after the pioneering MFIs reached profitability. Rate cuts were also linked to the emergence of new funding vehicles that created the liquidity for rapid growth by market leaders. In Uganda, the recently implemented MDI law may similarly allow larger MFIs to attract lower-cost deposits to fund their lending growth. In Bangladesh, profitable larger MFIs may have the financial capacity to absorb lower rates, but because there is no strong customer demand, MFIs do not have the incentive to reduce rates.

This analysis of the three markets suggests that, to achieve sustained general interest rate decline, *sufficiently large providers have sufficient incentive and sufficient ability to reduce rates*. However, the Bangladesh case illustrates that, although these conditions may be necessary, they may not be sufficient. Only time will tell whether the rating cap imposed by PKSF on some MFIs will encourage price competition to emerge in the next few years, or whether it will emerge from some other source, if at all.

## Implications

Price competition is likely to lead to lower interest rates in Uganda and Bolivia in the next three to five years. Even in Bangladesh, average interest rates have been reduced somewhat by fiat, though it remains to be seen whether this reduction can

be sustained, let alone enhanced. However, price is not the only, or even the primary, concern of clients. Clients place a lot of value on quality service, flexible product characteristics, and the availability of small loans. The benefit of true competition is that it should encourage firms to respond to changing consumer needs. Imposed price controls are risky because they limit the flexibility of providers to offer appropriate products to a diverse range of clients. Indeed, if prices are set too low, providers are likely to avoid smaller loans to poorer clients or to exit the market altogether.

MFIs in all three markets—and elsewhere as well—should prepare for the effects of intensifying competition, including interest rate competition. Most of the MFIs interviewed in Uganda and Bolivia are well aware of this. By pursuing lower funding costs and increased efficiency, most are seeking to build the headroom to sustain their profitability despite rate reductions. As long as rate reductions do not lead lenders to eliminate small-size loans, decreased rates should have the positive effect of expanding the overall market. More borrowers will be able to afford the minimum installment necessary to access microloans.

According to the MFIs interviewed in this study, strategies for competing on brand—which are expected to emerge in later, more mature phases of market development—have not yet been given much attention. By contrast, retail banks generally pay close attention to branding. As banks increasingly enter microcredit markets, MFIs will be forced to compete against well-established bank brands. MFIs soon will find that they need sound branding strategy to survive. They need to start investing now in building a strong brand. Doing so will benefit providers by allowing them to set prices rather than to take them.<sup>31</sup>

Consistent policies are needed to promote fair competition and create the conditions discussed earlier for lower interest rates to materialize. When these conditions are satisfied, the process of rate decline

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<sup>31</sup> For a useful introduction and summary to issues of corporate brand and identity in microfinance, see *MicroSave* Briefing Note 27, available at [www.microsave.org](http://www.microsave.org).

will start, or accelerate if it is already under way. Such policies may include the following:

- Requiring transparent, comparable pricing by providers
- Promoting consumer financial literacy
- Collecting and assessing credible market-level information<sup>32</sup>
- When communications infrastructure allows, developing reliable consumer credit bureaus to allow borrowers to build a good credit record that is accessible to competing lenders<sup>33</sup>

For donors interested in promoting pro-consumer microfinance, this study underlines the importance of several interventions that have “public good” features. These would include support to do the following:

- collect and disseminate credible market information, whether by regulators or industry bodies
- enhance consumer education
- improve financial infrastructure, such as the development of credit bureaus, but also the

training and support of financial regulators and competition authorities

In addition to the benefits to the consumer, fair competition in an industry enables more productive firms to survive and grow. This, according to a recent authoritative study of economic development, “is the most important long run determinant of productivity and so prosperity.”<sup>34</sup> Microfinance, and the societies in which it functions, will ultimately benefit from intensifying competition.

<sup>32</sup> Several key competitive indicators, such as number of clients, weighted average rates, and the level of market saturation, should be collected and tracked consistently over time. This could be done by the regulator (as in Bolivia) or an industry body (as in Bangladesh).

<sup>33</sup> In the absence of such information-sharing mechanisms, competition is likely to lead to increased multiple indebtedness of clients (McIntosh, C., A. de Janvry, and E. Sadoulet, “How Rising Competition Among Microfinance Institutions Affects Incumbent Lenders,” Draft paper, August 2004).

<sup>34</sup> Wolf, M., “The Tyranny of Vested Interests,” *Financial Times*, 17 January 2006. Book review of William Lewis, *The Power of Productivity*, University of Chicago Press, 2004.



## Annexes

### Annex I Data Sources

	Bangladesh	Bolivia	Uganda
<b>Interviewees</b>	ASA BRAC Buro-Tangail Grameen Bank Islamic Bank PDBF SFDW	Banco Los Andes Banco Sol FADES FIE, SA PRODEM	Cerudeb FSDU Postbank Stanbic Bank UFT UGAFOD UMU Another MFI
<b>Overall market data</b>	Market data reported are based on CDF data, with Grameen Bank numbers added.	ASOFIN data, covering regulated MFIs and one unregulated MFI in the process of becoming regulated; also Gonzalez-Vega & Villafani (2004) is a valuable source.	In absence of central data source, historic data were obtained from 7 leading MFIs constituting 58% of the estimated Ugandan market for microcredit. These were used to compile weighted averages of interest rates and return on equity. This was then compared with and complemented by Ugandan country-level data supplied by The MIX ( <a href="http://www.themix.org">www.themix.org</a> ).



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