



Are Microlenders Exploiting the Poor?

On Interest Rates, Usury and Justice

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Introduction

Microfinance: the practice of extending credit to poor or low-income clients

This practice has received global attention recently:

- UN declared 2005 the 'Year of Microcredit'
- Nobel Peace Prize 2006 to Muhammad Yunus and the Grameen Bank (Bangladesh)

General idea: access to credit facilitates self-employment and entrepreneurship → enables the poor to manoeuvre themselves out of poverty

M. Yunus: "Microfinance will make poverty history"



Introduction

Most salient criticism: interest rates are exorbitant

- Bangladesh's Minister of Finance has referred to present rates as "extortionate"
- Prime Minister of Cambodia has asked microfinance institutions (MFIs) to reduce interest rates
 - Over 40 developing countries have imposed mandatory interest rate ceilings to address similar concerns
- 2006: Around 50 branches of two major Indian MFIs closed down after allegations of "usury" and "extortion"
- 2007: Mexican MFI Compartamos is criticised after making a successful IPO possible by interest rates of over 100%

Introduction

Country	Commercial Bank Rates (APR)	Microfinance Institutions (APR)	Informal Sources, e.g. moneylenders (APR)
Indonesia	18%	28-63%	120-720%
Cambodia	18%	~45%	120-180%
Nepal	11.5-18%	18-24%	60-120%
India	12-15%	20-40%	120%
Philippines	24-29%	60-80%	~120%
Bangladesh	10-13%	20-35%	180-240%

Source: Wright and Alamgir 2004



Introduction

My question: Is it ethically defensible to charge as much as 20-80% interest when lending to the poor?

I will discuss:

1. Interpretations of the allegation of “usury”
2. Possible criticisms from procedural justice
3. Possible criticisms from distributive justice
4. Elaboration on my own tentative position

My answer: Yes.

It would certainly be *preferable* if MFIs could charge lower interest rates, but the responsibility for making this possible lies with other parties. The typical MFI does nothing wrong by charging so high interest rates.



The allegation of “usury”

Prohibitions against usury have a long history: All of the major religions contain condemnations of usury.

Exodus 22:24: “If you lend money to My people, to the poor among you, do not act toward them as a creditor; exact no interest from them”

Classical condemnations tend to be:

- Extremely general: “usury” was all financial interest.
- Poorly justified: often based on misconceptions, e.g. on the “unnaturalness” of “money begetting money”

Are there more fruitful ways of understanding the modern allegation of usury?



The allegation of “usury”

First fruitful interpretation: Idea about proper moral motivation

“It was not the everyday use of money which religious leaders condemned, but the love of money as an end in itself” (Visser and MacIntosh 1998)

My interpretation: When dealing with the poor, making money should not be your ultimate aim but rather helping the poor.

This is partly how Yunus (2006) responds: “I have been vocal about interest rates because making money is not our goal, it’s reaching people and helping them get out of poverty”



The allegation of “usury”

This idea is not extreme: Certainly okay to do business with the poor. However, charging them too much is an indication of improper motivations.

But do MFIs have improper motivations?

Some evidence to the contrary:

- MFIs themselves say their primary goal is poverty alleviation
- Microfinance is NGO-based. (Most MFIs are NGOs, cooperatives, public banks, etc. In the few that are for-profit, most shares are usually owned by NGOs.)
- 60% of MFIs reported negative return on assets in 2006
- 2/3 of the profitable ones were not-for-profit



The allegation of “usury”

Critics may say:

1. The fact that MFIs charge very high interest rates itself shows that they have improper motivation (a fully virtuous agent would not do so)

→ Further argument needed to establish this

2. The picture above is simplistic: problematic trend towards MFIs becoming for-profit.

- MFIs often forced to become for-profit in order to be able to take deposits
- Serious risk of ‘mission drift’
- Compartamos case in point



The allegation of “usury”

Second fruitful interpretation: Idea about inequitable redistribution

“The observation that usury acts as a mechanism by which ‘the rich get richer and the poorer get poorer’ is common to several traditions” (Visser and MacIntosh 1998)

Loans are typically products sold by someone *with* capital to someone *without* capital. Adding interest here increases inequitable distribution in society.

This seems to be CGAP’s (2009) response: “Interest rates are unreasonable if they take money from clients and deposit ‘excessive’ profits into the pockets of MFI’s private owners”



The allegation of “usury”

Problems with the appeal to inequitable redistribution:

- Not all loans go from relatively richer to relatively poorer
 - Not all effects of the transactions are considered. In microfinance, the idea is that access to credit can help poor people get out of poverty!
 - Once again, 2/3 of the profitable MFIs in 2006 were not-for-profit. The original NGOs owned most of the shares in a majority of the others.
- Whereas the trend towards privatisation may be troubling, the general allegation of inequitable redistribution fails.



Arguments from procedural justice

Are current interest rate levels in microfinance unjust, unfair or exploitative in any other sense?

Straightforward / fairly non-committed view on justice: It is wrong or unjust to directly force another to a certain exchange

Procedural justice: Only voluntary agreements between fully consenting adults (i.e. free moral agents) are just

Conception of exploitation: One agent taking advantage of (or making a transaction with) another under some conditions of impaired voluntariness, consent or agency



Arguments from procedural justice

Are current MFI practices exploitative in this sense?

Common argument from proponents of microfinance: High repayment rates indicate voluntariness – global average in 2006 was 98.1%!

But: the important question is not whether the poor pay back but why they pay back

Slight worries:

- Allegations of abuse in the southern India case
- More generally, the group lending model

However, the poor also come back for more loans



Arguments from procedural justice

More interesting conception of exploitation: Exploitation by indirect force

Transactions are in one sense involuntary if you accept them because you have no (acceptable) choice

Here the force comes from the situation and not from the exploiting agent. But it is nonetheless exploitation

High repayment rates is not an argument here

However, how should we understand “no (acceptable) choice”?

“Lack of access to cheaper credit” → we all want that!



Arguments from procedural justice

One idea: The problem is that the microfinance market is less than perfectly competitive

“In non-competitive markets, the clients may well decide to retake a loan even if the price is exorbitant” (Hudon 2007)

CGAP (2007) agrees: “The Compartamos IPO gives us reason to rethink our previous optimism about how quick competition would fix the problem of high interest rates”

But does this constitute taking advantage of the poor

“Law of diminishing return” suggests that poor clients will still be prepared to accept high interest rates even in perfect markets



Arguments from procedural justice

Imagine a hypothetical woman who has a dozen investment possibilities, each of which would require exactly \$100, and each of which produces a different level of return. Further, assume that she begins with no cash whatsoever. If she suddenly receives \$100, she will look through her range of investment possibilities and spend her money on the one that offers the very highest return. If she receives a second \$100 packet, she will look through the remaining eleven possibilities, and choose the best return out of this group (none of which will be as attractive as the one on which she spent her first \$100). Each time she receives an additional packet of \$100, her investment choice will be less attractive than any of her previous choices.

This example is highly stylized, but it does illustrate the tendency for returns to diminish as each additional unit of capital is added to the equation, all other things being equal. [...] Compared to [a large industrial company], the microentrepreneur can often wring greater relative benefit from additional units of capital, precisely because she begins with so little capital. And because she can use this capital more profitably, she can pay a higher interest rate and still come out ahead.

(CGAP 2002)



Arguments from procedural justice

→ Does exploiting the lack of competition from other banks constitute exploiting the poor?

Other possibilities (from Hudon 2006-7):

- The poor wouldn't accept these levels in "fair" bargains on a perfect market (where the cooperative surplus is distributed fairly, or certain unjust claims are ruled out)
- Clients are exploited when they are charged interest rates higher than what they have a legitimate justice-based claim to

All of these suggestions involve ideas from distributive justice – what a perfectly just society would be!



Arguments from distributive justice

The most straightforward intuition about what is problematic with microfinance interest rates: it is unfair/wrong that the poor get a worse deal than the non-poor

But what would a fair interest rate when lending to the poor be?

The intuition above is compatible with three different views:

- The poor should get at least somewhat reduced rates
- The poor should get the same rate as the non-poor
- The poor should get a lower rate than the non-poor

How should we decide this matter?

The present literature is remarkably underdeveloped



Arguments from distributive justice

One suggestion (Hudon 2006): import ideas from Rawls' theory of social justice

But Rawls suggests that issues about price fairness are only secondary; what matters is the justice of the whole system (and whether defects are compensated for elsewhere)

This suggests two possible ways forward:

(1) Develop a theory of the just distribution of interest rates *per se*

(2) Work out what weight should be given to interest rate factors vis-a-vis other factors in a more general theory of social justice



Arguments from distributive justice

Example of (1): M. Yunus suggests that access to credit should be regarded as a human right

Not just any credit but affordable credit – a reasonable rule of thumb is not more than 15% over and above the cost of funds

Example of (2): Critics of Yunus suggest that other matters are more important for social justice

- Infrastructure (telecom, roads, education)
- Competition and efficiency
- Credit as a tool to secure more basic human rights: e.g. to food and shelter

This would reduce interest rates, but only indirectly



Arguments from distributive justice

The present argument: Clients are treated wrongly when they are charged interest rates higher than what they have a legitimate justice-based claim to

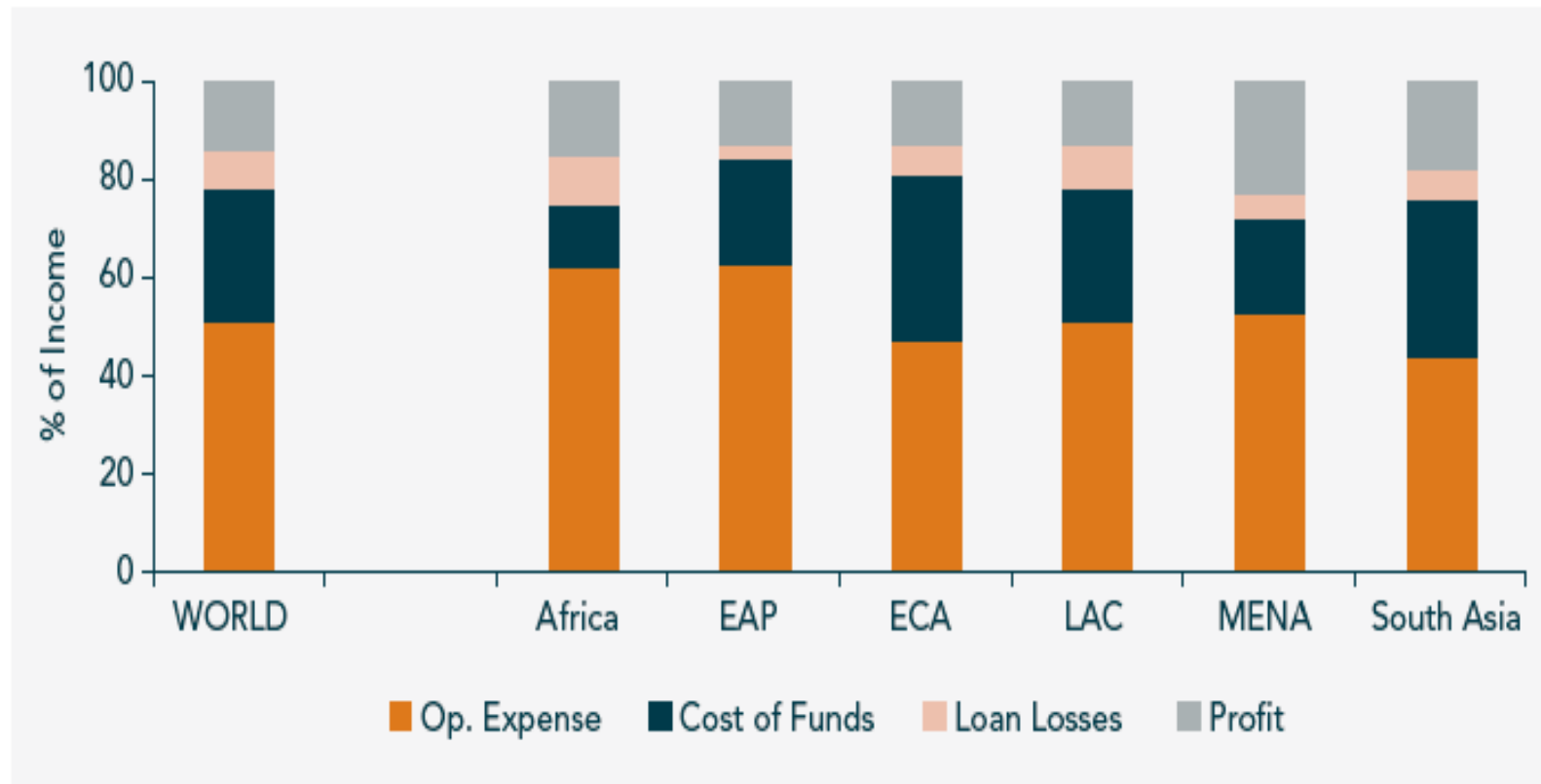
Let us assume that, on all plausible theories of distributive justice, the poor would have a legitimate claim to rates lower than today (either directly or indirectly)

I suggest that the present argument fails to adequately separate the politics from the ethics

Another salient kind of “lack of choice”: MFIs’ costs effectively prevent them from reducing interest rates without reducing outreach

Arguments from distributive justice

Figure 4: Costs and Profits as Percentage of Income, 2006



Note: 554 sustainable MFIs reporting to MIX for 2006 weighted by GLP. The Unit Desa system of Bank Rakyat Indonesia is excluded from this calculation because its reported cost of funds reflects artificial pricing arrangements between Unit Desa and the rest of the bank. The income on which the percentages are based is interest yield plus other income minus taxes.

(Source: Rosenberg et al. 2009)



Arguments from distributive justice

Is the appeal to costs just an excuse for MFIs not being able to do the right thing?

No. In order for it to be wrong of you to fail to give someone what they have a legitimate justice-based claim to, you plausibly need to be able to do that – and in a helpful way

As long as MFIs are helping the poor and they couldn't help them more, I suggest that the present allegation fails

While it certainly would be preferable if MFIs could reduce their interest rates, they presently do nothing wrong



Arguments from distributive justice

While it is difficult for *MFIs* to lend at lower rates, *other parties* could certainly do much more to bring interest rates down

→ Complaint about the lack of action on their part!

- Governments / the international political community could do more, either directly (subsidies) or indirectly (e.g. improvements in infrastructure) → a political issue!
- Mainstream commercial banks could lend at lower cost of funds
- Overseas investors now have the opportunity to support microfinance ventures through MIVs



My tentative position

What is the outcome of all this in terms of theory?

I have suggested that:

- Typical MFIs do nothing wrong by charging today's interest rate levels – they seem to be doing their best for the poor
- However, other actors should do more to reduce interest rates – they are not doing their best for the poor

General idea: All parties have moral reasons to do their best to ameliorate the situation for the poor



My tentative position

This is no “everything goes” view! MFIs should reduce interest rates as much as possible without worsening the situation for the poor

There may be some possibilities to cut costs: (CGAP 2009)

- Increasing reliance on deposits may cut cost of funds
- Unrealistic to assume MFIs operating at max. efficiency

I am not advocating complete focus on financial sustainability!

The general argument from this camp: subsidies are erratic
→ But when they are available, MFIs should not forgo the opportunity to increase outreach!



My tentative position

Governments, the international political community, mainstream banks and overseas investors should do so much more

Exactly what should they do? Direct or indirect support?

I don't know, but this is the issue we should be discussing. Not the issue of whether MFIs are acting wrongly or not!

THANK YOU!