The role of financial regulations in financial inclusion: The case of a lending rate restriction on microfinance institutions

Daiju Aiba (JICA Research Institute)

Financial regulations play a significant role in determining a market structure and behaviors of financial institutions. In April 2017, an interest rate cap policy at 18% was newly introduced in the Cambodian microfinance institutions (MFIs), where there has been no restriction on lending rates previously. The policy was aimed at mitigating a rising issue of over-indebtedness for borrowers. However, in the literature of interest rate cap, there are mixed results with effects of this policy on loan provision of financial institutions. In this regard, we provide empirical evidence on effects of the interest rate cap policy by exploiting unique MFI-district pair-wise data in Cambodia. The data allows us to investigate changes in MFI's lending in detail, especially in geographical outreach.

Although interest rate cap policy (sometimes also referred to as interest rate ceiling or usury laws) is a widely common practice in both of developed and developing countries, a strand of the literature presents mixed results of real effects of this policy on financial institutions and accumulation of evidence is not sufficient. Alessie et al. (2005) find a positive impact on credit supply in Italian consumer markets, and Benmelech & Moskowitz (2010) and Rigbi (2013) find a negative impact in U.S. loan markets of firms and consumers. The theoretical argument of the regulation on the banking sector suggests that an interest rate cap policy could have positive and negative effects, depending on conditions of loan markets, such as competitiveness and current policies of governments. Thus, further empirical investigation into the effects of interest rate cap is needed in the literature of interest rate cap policy.

In addition, it is noted that there is a paucity of studies on effects of financial regulation on MFIs. Most of prior empirical studies are focused on developed countries, especially on behaviors of commercial banks and consumer loan markets. However, discussion in previous studies are not directly applicable to financial systems in the developing countries, where MFIs play a significant role in providing credits with the poor and SMEs. Originally, MFIs are aimed at addressing poverty reduction issues, and the nature of MFIs is not only pursuing the profit, but also improving outreach to extend loans to the poor. Thus, regulations on MFIs should be implemented with consideration of this MFI's nature. However, there is no systematic investigation into the effect of interest rate cap policy on MFIs. Our empirical findings are useful for the policy-makers and shed a light on the debate on the effectiveness of financial regulation on the MFI sector.

As a result, we find that the policy introduction negatively affected MFI loan provision in the sense that MFIs were likely to maintain profits by reducing the growths of number of borrowers and increasing loan sizes. In particular, MFIs with higher pre-regulated interest rates are more likely to reduce loan provision after the policy implementation. In the meantime, the policy did not necessarily have harmful effects on MFIs' outreach. After the policy introductions, MFIs with lower pre-regulated interest rate were likely to increase growths of amounts of loans and numbers of borrowers in less developed areas. These results suggest that interest rate cap policy affect MFIs differently depending on pre-regulated interest rate they charge on borrowers, and MFIs with higher pre-regulated interest rates are more likely to be affected and to reduce loan provision and increase the size of loans in order to maintain the lending policy toward profit-orientation. However, MFIs with lower pre-regulated interest rate circumvent the policy, and further increase loan provision to people in less developed areas. In other words, the interest rate cap policy lead to reduction in outreach of MFIs with higher pre-regulated interest rate, while such reduction was compensated by increases in outreach of MFIs with lower pre-regulated interest rate.