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Microfinance in Palestine: Are loans too expensive and should interest rates be capped?

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The microfinance sector stands at USD 60-100 billion and serves hundreds of millions of people worldwide [1]. In Palestine, with an outstanding portfolio of more than USD 170 million and almost 73,000 borrowers (38% women) [2], microfinance institutions (MFIs) play a crucial role in promoting financial inclusion among marginalized groups, by offering lending services to those who have limited or no access to finance. Since 2011, when the decree regulating the microfinance sector was issued, six MFIs have been licensed by the Palestine Monetary Authority (PMA), whose mandate is to oversee their compliance with the legal framework, ensure client protection and support their operations with key services and information – such as the credit registry.

In Palestine as in other countries, a debate over interest rates and other fees applied by MFIs is growing. It is a common belief that loans offered by local MFIs are overpriced and thus, large shares of the population – in particular micro-entrepreneurs, small-scale farmers and women – cannot afford to take up credit. Many stakeholders are also advocating for a government intervention to set an interest rate ceiling for specific economic sectors or beneficiary groups, most in need of finance.

Are Palestinian MFIs asking for disproportionate interest rates and fees? Are they inefficient or making too much profit? Based on the experience in other countries, are “interest rate caps” effective in fostering financial inclusion among marginalized groups? This brief aims to shed light on these issues and provide policymakers and donors in Palestine with some general recommendations.

THE “REAL” COST OF LOANS

Even within the same country, comparing the cost of loans offered by different MFIs can be extremely challenging. In Palestine, for instance, most of the MFIs only state “flat” interest rates, which are supposed to be easier to calculate and be explained to clients. However, unlike the “declining” interest rate formulation, the “flat” one does not allow comparison between loans having different maturities and repayment schedules. Moreover, many MFIs also apply a set of fees or services costs – such as commissions, upfront fees, life insurance, etc. – varying from one loan product to another and which affect the overall cost of loans.

It is a widely accepted methodology – adopted in this brief as well – to use the ratio between the total income from loans of a given MFI and its gross loan portfolio (GLP) as a “proxy” to capture the average “real” cost of loans. This measure will be hereafter referred to as “interest yield” [3].



THE DETERMINANTS OF LOAN PRICING AND THEIR TREND

MFIs cover their costs – which include the cost of funds [4], loan loss expenses (i.e. unpaid loans) and operating expenses – through the collection of the interest rate and other fees. The difference between the total income and costs is the profit. Therefore [5]:

$$\text{Income from interest rate} + \text{Income from fees} = \text{Cost of funds} + \text{Loan loss expense} + \text{Operating expense} + \text{Profit}$$

To ensure the financial sustainability of MFIs, the above equation shall hold. Any change on the right side (costs and profit) shall be compensated on the left side (income) and ultimately, imply an adjustment in the loan pricing – interest rate and/or fees.

A 2013 study of the Consultative Group to Assist the Poor (CGAP) [6], analyzing data from 2004 to 2011 on 456 MFIs worldwide, shows that on average, income from interest rate and fees accounts for 27% of GLP – 26% in the Middle East and North Africa (MENA) region. Historically, interest yield has declined, from an average of 30% in 2004 (same value in the MENA region) to the above-mentioned level in 2011.

According to the research, this was mainly due to an improvement in the MFIs operating expenses, which are the main driver of interest yield – and therefore, loan pricing. While in 2004 operating costs accounted for about 17% of GLP, in 2011 they dropped to 14%. However, the decline was only partially reflected on the loan pricing, as it was offset by an increase in the cost of funding (from 5.2% to almost 8% of GLP) and loan losses (from 2.4% to 3.6% of GLP). Consequently, the MFIs net profit margin lowered by almost half, dropping from 5.8% to 2.6% of GLP.

To the best of our knowledge, the 2013 CGAP study is the latest available analysis on loan price determinants across different regions. Data presented in the following sections suggest that from 2011 on, this declining trend inverted, as interest yield increased by almost six percentage points, while the ratio between operating expenses and GLP by almost eight. What was the main driver of the global increase and how did it reflect on MFIs outreach? A comprehensive, updated study on these issues could be an important subject for further research.

ARE PALESTINIAN MFIs INEFFICIENT OR MAKING TOO MUCH PROFIT?

Before discussing loan pricing in Palestine, let us take a closer look at the performance of Palestinian MFIs in terms of efficiency and profitability, with respect to other countries and regions in the world. Table 1 shows a set of indicators measuring MFI efficiency. For Palestine, data is presented both including and excluding UNRWA, one of the six licensed MFIs. In fact, UNRWA is a local MFI established under the United Nations system and whose mandate is to provide microfinance services specifically to refugees. As a consequence, it is less market-oriented than other players and therefore, its inclusion within the sample [7] might affect some of the results.



	Operating Expense / GLP			Cost per Borrower (USD)			Borrowers per Credit Officer		
	2013	2014	2015	2013	2014	2015	2013	2014	2015
World	25.1% (880)	24.8% (860)	23.9% (193)	285.99 (784)	340.87 (781)	415.03 (190)	348 (823)	326 (855)	283 (172)
MENA	23.8% (26)	23.9% (25)	22.4% (11)	151.60 (25)	151.32 (25)	156.09 (11)	243.32 (22)	268.07 (27)	253.83 (12)
Middle East (*)	22.6% (15)	24.4% (14)	21.5% (8)	170.43 (14)	181.1 (14) 4	180.25 (8)	246.42 (12)	293.27 (15)	276.25 (8)
Palestine	21.1% (4)	21.3% (4)	20.9% (2)	289.75 (4)	286.25 (4)	345.00 (2)	238.5 (4)	217.6 (5)	146 (2)
Palestine (excluding UNRWA)	16.7% (3)	16.5% (3)	20.9% (2)	274.00 (3)	268.67 (3)	345.00 (2)	260 (3)	226.5 (4)	146 (2)

TABLE 1 – EFFICIENCY AND PRODUCTIVITY INDICATORS

Source: MixMarket [8] and authors' calculations, June 2016

(*) Egypt, Lebanon, Jordan and Palestine; number of reporting MFIs between brackets.

In terms of operating expenses as compared to the GLP, Palestinian MFIs are well below the regional as well as global average and therefore, seem to be efficient. With regards to productivity (cost per borrower and borrowers per loan officer), however, Palestinian MFIs present significantly higher levels than the regional average, suggesting that there is still room for improvement.

At the same time, this might be a consequence of the political and economic environment (i.e. higher price level than in the neighboring countries) as well as the specific structure of the local market. On the one hand, in fact, the average outstanding balance per borrower (i.e. a proxy of the average loan size) is more than twice that of the Middle East and MENA regions – in 2014, USD 1,976 including UNRWA and USD 2,179 excluding UNRWA; while it was USD 1,044 and USD 909, for the Middle East and MENA respectively. On the other hand, the relatively small size of the Palestinian market might limit the achievement of economies of scale. The reasons explaining this significant difference between the average loan size in Palestine and the neighboring countries, however, should be a matter of further research.

	ROE			ROA			Loan loss rate		
	2013	2014	2015	2013	2014	2015	2013	2014	2015
World	8.8% (844)	7.6% (848)	5.7% (190)	1.4% (846)	1.7% (851)	1.3% (191)	1.2% (775)	1.4% (764)	1.7% (192)
MENA	8.3% (22)	9.3% (25)	7.1% (11)	3.9% (22)	3.7% (25)	4.0% (11)	1.2% (20)	0.5% (24)	1.7% (11)
Middle East (*)	9.9% (14)	8.1% (14)	9.0% (8)	4.7% (14)	4.0% (14)	5.7% (8)	0.4% (11)	0.5% (13)	1.8% (8)
Palestine	2.0% (3)	-0.4% (4)	2.3% (2)	1.6% (3)	-0.8% (4)	1.8% (2)	0.4% (4)	0.3% (4)	4.1% (2)
Palestine (excluding UNRWA)	2.1% (2)	0.4% (3)	2.3% (2)	1.5% (2)	-0.2% (3)	1.8% (2)	0.2% (3)	0.1% (3)	4.1% (2)

TABLE 2 – PROFITABILITY INDICATORS

Source: MixMarket [8] and authors' calculations, June 2016

(*) Egypt, Lebanon, Jordan and Palestine; number of reporting MFIs between brackets.

Even with respect to their profitability, data in table 2 suggests that Palestinian MFIs, when compared to their peers at the regional and global level, are well below the performance average. In 2014, the return on equity (ROE) [9] for the average microfinance player in the MENA region was 23 times higher than the one achieved by an MFI in Palestine. Finally, as compared to other financial institutions in the Palestinian market, at the end of 2014 the average ROE was 9.6% for local commercial banks, but 0.4% for MFIs; and the return on assets (ROA) was 1.2% for banks and -0.2% for MFIs [10].

ARE PALESTINIAN MFI LOANS TOO EXPENSIVE?

According to the figures available, the answer is clearly no. Data in table 3 compares interest yields in Palestine with the average at the regional and global level. Palestinian MFIs total income from interest rate and fees collection accounts for less than one-fourth of the GLP, while in most of the other countries, including the Middle East and MENA regions it is almost one-third. It is also important to mention that among Palestinian MFIs, interest yield significantly varies: two MFIs reported an interest yield above 20%; while the others ranged between 16% and 19%.

	Interest yield		
	2013	2014	2015
World	32.3% (880)	32.5% (860)	32.7% (193)
MENA	32.3% (26)	32.1% (25)	32.9% (11)
Middle East (*)	30.9% (15)	32.0% (14)	32.2% (8)
Palestine	26.3% (4)	22.8% (4)	22.7% (2)
Palestine (excluding UNRWA)	22.3% (3)	19.3% (3)	22.7% (2)

TABLE 3 – INTEREST YIELD

Source: MixMarket [8] and authors' calculations, June 2016

(*) Egypt, Lebanon, Jordan and Palestine; number of reporting MFIs between brackets.

On the other hand, as shown in table 4, a comparative analysis of the portfolio at risk (measured by PAR >30 days) suggests that part of the Palestinian MFIs' income from interest rate and fees is deteriorated by a lower quality of the portfolio.

	Portfolio quality (PAR >30)		
	2013	2014	2015
World	6.49% (843)	5.29% (883)	6.90% (199)
MENA	4.20% (22)	4.60% (26)	7.30% (12)
Middle East (*)	5.70% (12)	5.20% (15)	2.20% (8)
Palestine	10.80% (4)	11.80% (5)	6.00% (2)
Palestine (excluding UNRWA)	8.50% (3)	11.20% (4)	6.00% (2)

TABLE 4 – PORTFOLIO QUALITY (PAR >30 days)

Source: MixMarket [8] and authors' calculations, June 2016

(*) Egypt, Lebanon, Jordan and Palestine; number of reporting MFIs between brackets.

INTEREST RATE CAPS AND ACCESS TO FINANCE

In many countries, interest rate caps are imposed to reduce the cost of borrowing, prevent predatory lending and indirectly subsidize strategic economic sectors or groups with limited or no access to credit. Interest rate ceilings, which have a long history and are set according to different definition methodologies (e.g. fixed rate versus changing with the prevailing market conditions), are nowadays used in more than sixty countries worldwide [11]. In Zambia, for instance, MFI loans are capped at the annual rate of 42%; while in Ecuador, at about 30%; in India, MFIs can charge a maximum rate of 10-12% over the cost of funding and in Bolivia, microfinance loans cannot go beyond 11.5% per year.

Notwithstanding the good intentions of legislators, evidence suggests that interest rate caps did not succeed in improving access to finance, especially for those left out of the financial market. On the contrary, and especially when ceilings are set at an excessively low level, regulating the cost of loans can have a negative impact on the microfinance market – and primarily hurt the poor. Let us examine the effects of interest rate caps, based on the available evidence.



Microfinance market contraction – Two years after Bolivia introduced the caps in August 2013, the number of borrowers served by local MFIs dropped by 35,000. Moreover, the credit market growth rate fell from 20% to 16% per year and small and medium enterprises were the most severely hit segment, as their credit growth rate became negative [12]. Whereas in the previous years, Bolivia achieved either the first or second place in the Center for Financial Inclusion international ranking, in 2014 the country suddenly dropped to ninth place in terms of financial inclusiveness for the poorest [13]. Similarly, in 2001 when interest rate regulation was introduced in Nicaragua, the MFIs portfolio growth rate drastically fell from 30% to 2% per year [14]. Finally, according to World Bank research, most of the countries with interest rate caps have a credit-to-GDP ratio below the regional average – as well as a lower share of population who within the last twelve months took out a loan [11].

Less to the poor, women and remote areas – Serving economically or geographically marginalized groups is more costly than serving average clients. According to a recent econometric study on the microfinance sector in Latin America and the Caribbean, a 10% increase in the percentage of women borrowers increases operating costs by almost 6%, keeping the total number of borrowers and other variables constant [15]. By comparing data from seven countries, the study also shows that where interest rates ceilings are imposed, MFIs tend to leave poor people, women and people in remote areas unserved, while concentrating their activities on less costly and risky clients. A similar trend was also observed in South Africa [16] and Western Africa countries [17]. In India, following the introduction of the interest rate cap in 2011, many MFIs withdrew from rural areas, leaving more than 400 million people with no more access to financial services [13].



Loan upscaling and reduced product diversity – Some key studies highlighted that if the ceiling is too low, MFIs find it difficult to recover high operating costs for managing a large number of micro and small loans. Therefore, in Bolivia [12], Ecuador and other countries where caps are in place [15], it was observed that MFIs tend to increase the average size of loans – meaning that most likely they tend to focus on the higher end clients, rather than the poor. In some countries, this eventually led to a reduced diversity of financial products offered by MFIs to low-income clients [11].

Less transparency and client protection – In the MENA region [18], South Africa and Armenia [17], interest rate caps pushed MFIs to cheat on the regulation, by adding new hidden fees to the lending products, which ultimately reduced market and price transparency. Moreover, research suggests that low-end clients left unserved by MFIs turned toward illegal or informal lending, where they enjoy no protection at all [11]. Finally, if a stringent interest rate policy is in place, unregulated MFIs have fewer incentives to get out of the “grey zone”, with a negative impact on client protection [19].

As compared to the evidence-based studies highlighting the negative effects of interest rate ceilings, very few advocate for a strict regulation of lending prices. Moreover, most of this body of research focuses on the price-sensitivity of low-end clients with respect to changes in interest rates [20], while leaving aside the broader, macro-level effects of loan price restrictions presented above.

CONCLUSIONS AND RECOMMENDATIONS

From the data available, Palestinian MFIs seems to be more efficient than the regional and world average. Productivity indicators, however, suggest that there is still room for improvement. With respect to profitability, they do not seem to be over performing – but on the contrary, ROE and ROA levels appears to be significantly lower than those achieved by MFIs in Jordan, Lebanon, Egypt as well as the MENA region as a whole. This reflects the cost of lending services, which seems to be less than the regional and global average. Therefore, we can conclude that microfinance loans in Palestine cannot be considered overpriced.

Moreover, based on the evidence available, interest rate caps are not an effective policy to foster financial inclusion. Among the “side effects” of ceilings, in fact, it was observed that the microfinance market is likely to contract; MFIs tend to withdraw from the most expensive clients and regions to serve – the poor, women and rural areas – and focus on the better-off market segments; and finally, price transparency and client protection decrease. Furthermore, imposing an interest rate cap in Palestine would most likely have a negative impact on the already-low ROE achieved by MFIs; in such a scenario, local and international funds would be discouraged in investing in equity and ultimately, MFIs lending outreach would be limited [21]. As pointed out in a 2010 Inter-American Development Bank study [15], “improved operation efficiency – a key driver of lower rates – comes primarily from five sources: competition, reinvestment of profits, learning by doing, pressure from donors and investors on MFIs to be socially responsible and the absence of interest rate caps”.

The following key recommendations for policymakers and donors in Palestine can be drawn from the analysis:

- Increase customer protection and price transparency, by moving the entire industry towards a wider use and advertisement of interest rates in the “declining”, rather than “flat”, calculation methodology.
- Design information sharing tools, such as online platforms making it possible to compare different microfinance products offered by local MFIs.
- Decrease the cost of funds for MFIs– within the framework of the initiative “Start Up Palestine”, for instance, the Italian Agency for Development Cooperation, through the Palestinian Fund for Employment and Social Protection (PFESP), offers liquidity to local MFIs at the annual rate of 2% “declining”. To avoid market distortion, however, the provision of low cost funds to MFIs should be strictly linked to the condition of increasing the outreach among poor and marginalized entrepreneurs.
- Establish risk-sharing (e.g. equity funds) and/or risk-coverage (e.g. guarantee funds) facilities targeting specifically low-end clients, marginalized areas and economic sectors with limited or no access to finance. More generally, the provision of non-financial services (e.g. financial literacy training and business development services) to MFI clients helps in reducing their risk of default – and therefore, in the medium run, is likely to lower the cost of lending to the poor. In this sense, non-financial services should support poor and marginalized entrepreneurs in finding potential lenders; generating a viable business idea; and finally, getting them ready to lend.
- Foresee a set of financial incentives to increase the demand of loans and partially cover for their costs – for instance, through a “waiver system”, MFI clients fulfilling a set of eligibility criteria and conditions can obtain, from public or private institutions other than MFIs, a total or partial reimbursement of the interest rate.
- Improve the delivery of microfinance services and offer new financial products, with the goal of making the Palestinian microfinance sector more competitive and compliant with international best practices.
- At the governmental level, adopt a tax policy encouraging the growth and sustainability of the microfinance sector in Palestine.

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[2] SHARAKA – Palestinian Network for Small and Micro Finance (2016). “Outreach Report – First Quarter 2016”. In 2013, the total portfolio stood at about USD 92 million and the total number of borrowers at 54,210. In two years, the microfinance sector grew by more than 40% in terms of loan portfolio and 15% in terms of borrowers.

[3] Annual Percentage Rate (APR) is an alternative measure. However, unlike the interest yield whose calculation requires only the annual balance sheet, AFR computation is performed over a statistically significant sample of each MFI’s portfolio database – sensitive information, which MFIs tend not to disclose.

[4] As MFIs in Palestine are not allowed to collect savings from clients, loans are financed by the MFI own resources (i.e. equity) and loans (i.e. debt) obtained in the local or international market at commercial or preferential rates, ranging from 2% to 7% on an annual basis. The PMA currently requires MFIs to maintain a debt to equity ratio (i.e. leverage) equal to two.

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[7] From 2013, depending on the reporting year, annual data is available for a maximum of five out of the six licensed Palestinian MFIs. The six MFIs for which at least one report is available between 2013 and 2015 are ACAD, ASALA, FATEN, REEF, UNRWA and VITAS, accounting for more than 95% of the total outstanding portfolio in Palestine. The remaining MFI which did not report was recently established and offers micro-loans compliant with Islamic finance (AL-IBDAA).

[8] MixMarket database. [<http://www.themix.org>] The significant drop in the number of reporting MFIs in 2015, as compared to 2013 and 2014, is probably due to the fact that many MFIs have still to publish their consolidated financial statement for the last fiscal year. We expect that by the end of 2016, the database will include a larger sample for 2015.

[9] Return on equity (ROE) is generally considered a better indicator to measure the profitability of MFIs, as compared to return on assets (ROA). ROE, in fact, reflects the total profit achieved, as compared to the MFI owners' equity investment. On the other hand, ROA measures how well an MFI performs with respect to all the resources available for loans –own equity, liquidity and other funds borrowed by the MFI to finance lending activities.

[10] IFC West Bank and Gaza Office own calculations. The negative ROA for MFIs was most likely a consequence of the 2014 war in the Gaza Strip and the resulting increase in loan default rates.

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[21] As pointed out in the discussion above, MFIs are required to maintain a debt to equity ratio equal to two. Given the small equity base of most of the market players, the only alternatives for future expansion are local or international private sector equity or semi-equity investments. Interest rate caps, resulting in a lower ROE for MFIs, would discourage investors and therefore, limit the MFIs lending potential.

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