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Effects of Interest Rate Ceiling on Sustainability of Microfinance Institutions: Lessons from Tanzania

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Abstract

This study explores the effects of an interest rate ceiling on the sustainability of Microfinance Institutions (MFIs). Based on qualitative research which entailed collection of online data from 53 respondents and in-depth face-to-face interviews with 10 MFI practitioners in Tanzania, it is evident that an interest rate ceiling interferes with competitive market forces. Given that MFIs vary in size, operational capacity, customer segment and business model, applying a single blanket interest rate leads to capital and credit diversion, hidden non-interest charges, the emergence of informal lenders and a black market, the withholding of credit from risky markets and the closure of some MFIs. Accordingly, an interest rate ceiling impairs the sustainability of MFIs and reduces financial inclusion. The study demonstrates that while competition moderate interest rates, non-interest measures can be applied to protect customers from being exploited by unscrupulous lenders.

Keywords: Microfinance Institutions, interest rate ceiling, protecting consumers, sustainability of MFIs, Tanzania

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Introduction

The literature reports that interest rate ceilings are used by governments for a range of political and economic reasons, most common of which is to provide support to a specific area of the economy (Caballero-Montes et al., 2021; Miller, 2013; Mitra, 2009). However, in as much as the interest rate ceiling is a form of price control (Kar & Swain, 2014), there has been on-going debate on the rationale for imposing it in the financial market. On the one hand, the interest rate ceiling is perceived as a way of protecting consumers from unscrupulous lenders by helping to control predatory lending and reducing the cost of borrowing for consumers (Ochien & Odondo, 2018). On the other hand, it is argued that an interest rate ceiling increases financial exclusion by making financial service providers withdraw from risky markets and become less transparent about total loan costs (Ferrari et al., 2018). In view of this, the interest rate ceiling drives clients back to expensive informal markets where they have little or no protection (Maimbo & Henriquez Gallegos, 2014). It interferes directly with the free market and is likely to affect MFI operations, thereby increasing the inefficiency of financial service providers (Alshebami & Khandare, 2015).

While in some countries, financial institutions are encouraged to compete, and consumers are protected through consumer protection Acts, others have introduced the standard practice of MFIs having control of their interest rates. The underlying reason for having an interest rate ceiling on loans is that MFIs make excessive profits by charging vulnerable clients exorbitant interest rates (Miller, 2013). In Tanzania, for instance, the government passed the Microfinance Act in 2018 (URT, 2018) and the Microfinance Regulations in 2019 (URT, 2019), which compel MFIs to be registered by the Bank of Tanzania (BOT). When applying for a licence, MFIs are instructed to charge a maximum interest rate of 3.5% per month. Despite attempts by MFIs through the Tanzania Association of Microfinance Institutions (TAMFI, 2021) to justify varying interest rates based on their capital costs and lending models, the BOT insists on the ceiling provided. However, the view of MFIs is that enforcing a ceiling is not only against industry best practices and the spirit of the Microfinance Act 2018, but it will also negatively affect their sustainability (Kar & Swain, 2014).

Despite the contradictory views about the rationale for controlling the interest rate, there is scant empirical evidence on the effect of the interest rate ceiling on the sustainability of MFIs. While there are mixed views regarding the effect of the interest rate ceiling on financial inclusion and sustainability of MFIs, previous empirical literature (e.g. Mia, 2017; Caballero-Montes et al., 2021) has largely focused on consumer protection. Consequently, there is limited knowledge on the extent to which the interest rate ceiling affects sustainability of the growing MFI sector in Africa especially in Tanzania (Charles & Mori, 2017). It is true that the existing evidence shows that in Kenya and Zambia, the interest rate ceiling for banks was lifted after expansion of credit to the private sector was negatively impacted (Alper et al.,2020), and that this decision was informed by the World Bank and IMF studies (e.g. Maimbo & Henriquez Gallegos, 2014, Alper et al., 2020). However, this evidence does not resolve the academic dilemma, partly because the views of predominant financial service providers such as MFIs on their sustainability have not been adequately documented. In this connection, our logic is that, for MFIs to be sustainable, they must be able to cover their costs and make a profit that can be reinvested to fuel growth. The interest rate is conceptualised as a combination of funding costs, operating expenses, loan loss and profit (Prince et al., 2020)

This article explores the effect of a recently introduced interest rate ceiling on sustainability of MFIs in Tanzania. It demonstrates that the MFI sub-sector is not homogeneous as the service providers vary in size, operational capacity, customer segment, business model, and operational costs. Informed by the economic theory and the study findings, the article supports the view of encouraging competition to enable MFIs to become efficient, reduce costs and the interest rate. It expands the economic theory by suggesting that in an imperfect financial market like the one in Tanzania, consumer protection measures should be enforced to ensure that consumers are not exploited by lenders. In view of this, the article recommends enhancing competition, improving the financial protection consumers and enforcing disclosure of the terms and conditions of the loans rather than setting the interest ceiling.

The article is organised as follows. The next section presents key observations from the literature reviewed. This is followed by the methodology that was used to generate the data used in this study. The findings are then presented and discussed. Finally, the implications, limitations and areas for further studies are described.

Literature Review

In economic theory, the credit market is viewed like any other market. There are buyers (borrowers) and sellers (lenders) of credit, and the price of credit is the interest rate. Accordingly, the economic theory suggests that competition between financial institutions forces them to improve efficiency, reduce overheads and cut profit margins by bringing down interest rates (Campion *et al.*, 2010). In view of this, the market is not in a position to prevent lenders from exercising power over pricing or earning more than a normal return (Donna, 1982). Thus, if credit markets are competitive, the resulting interest rate will not exceed lenders' cost of providing credit. However, when competition is absent, consumers may face unreasonable interest rates (Mia, 2017). In this situation, interest rate caps protect consumers from usury, primarily by restricting the market power of lenders and force those with greater market power to reduce their interest rate, as if competition played an optimal role (Caballero-Montes et al., 2021). Consequently, the effects of interest rate ceilings greatly depend on the degree of competitiveness of credit markets (Cuesta & Sepulveda, 2018).

Nonetheless, market imperfections resulting from information asymmetry and the inability of a bank or MFI to differentiate between safe and risky borrowers (Madeira, 2019) may account for high interest rates, namely adverse selection (Charles & Mori, 2016), which is a result of different borrowers having different probabilities of repaying their loan (de Mel et al., 2011). High interest rates charged to borrowers may induce adverse selection and the probability of default as financers engage in credit rationing in a high interest rate environment. In this case, diligent and financially conservative borrowers would be forced out of the market by high interest rates, while borrowers not troubled by the possibility of default would not be deterred by high interest rates (Lensink et al., 2018). Thus, higher interest rates adversely separate bad credit risks from good credit risks, and the default rate on loans may rise as the interest rate rises. The problem is that interest rate ceilings are common at the lower end of the market where financial institutions use information asymmetry to justify high lending rates.

Proponents of interest rate caps on credit often support them in the spirit of protecting the poor from exploitation and abusive pricing. In their view, interest rate caps would help

mitigate some undesirable behaviours such as exorbitant rates, flat rates and extra fees, and lack of transparency (Caballero-Montes et al., 2021). Furthermore, as the interest rate rises, the borrower is given the incentive to choose projects with higher risk and so the default rate on loans would tend to rise (Lensink et al., 2018). Hence, the borrower's investment portfolio will contain a larger proportion of riskier projects as interest rates rise. As a result, the adverse selection effect can lead to a reduction in expected profits as the interest rate rises (Martin & Smyth, 1991). Caps on interest rates also protect borrowers against usurious lending practices and can be used to guard against the exploitation of vulnerable members of society (Miller, 2013). Where lenders are known to be very profitable then it might be possible to force them to lend at a lower rate in the knowledge that the costs can be absorbed into their profit margins (Caballero-Montes et al., 2021).

Opponents of interest rate caps claim that they affect the sustainability of financial institutions, especially those with higher funding and overhead costs (Ochien & Odondo, 2018). In this regard, MFIs incur higher costs than banks due to their small size and limited access to cheap sources of funds (Charles & Mori, 2016). MFIs need to charge high interest rates to cover their costs and ensure financial sustainability (Kar & Swain, 2014). Therefore, the imposition of a maximum price for loans magnifies the problem of their sustainability. It makes it difficult or impossible for formal and semi-formal micro lenders to cover their costs, driving them out of the market (Ochien & Odondo, 2018). Although financial institutions can remain profitable in the presence of interest rate caps, this may prevent them from investing in new markets. In extreme cases where ceilings are set at an unprofitable level, financiers may withdraw from expensive market segments because they cannot cover their costs (Alper et al., 2020). In some cases, low-income borrowers with few options for borrowing in the formal market could turn to unlicensed moneylenders, probably at a higher interest rate (Charles & Mori, 2017). In countries where interest rate caps do not cover fees and commissions, financial institutions may give the impression of complying with the ceiling but actually charge fees and commissions that are not considered part of the cost of the loan (Caballero-Montes et al., 2021). Moreover, when caps are not set too low, interest rates will still tend to rise toward the caps (de Mel et al., 2011).

The growing debate has triggered several empirical assessments of interest rate caps and their impact on financial inclusion and the sustainability of financiers in different countries. Most assessments attempt to establish the motivation for interest rate caps and their impact, particularly on expanding access to financial services. In terms of motivation, studies show that interest rate ceilings are generally justified because financial institutions make excessive profits by charging clients exorbitant interest rates (Miller, 2013). In Sri Lanka, for instance, the average real return on capital for micro enterprises was found to be 5.7% per month, well above the typical interest rate of 2-3% charged by MFIs (de Mel et al., 2011). Similarly, in Mexico, returns on capital were an estimated 20-33% per month, up to five times higher than market interest rates (ibid). However, in some cases, these high interest rates are charged by loan sharks, who operate mostly in informal markets, whereas treating regulated institutions as sharks by enforcing an interest rate ceiling can distort the market (Miller, 2013).

Altogether, most studies have shown undesirable impacts of interest rate ceilings. For example, Madeira (2019) analysed the impact of a law introduced in Chile in 2013 to reduce the maximum legal interest rate for loans from 54% to 36%. The results showed that being

above the interest rate cap reduced borrowers' probability of accessing credit by 8.7% on average, while other results showed that the new law prevented 9.7% of borrowers from obtaining a bank loan. Likewise, Cuesta & Sepulveda (2018) found that the policy reduced interest rates by 9%, and the number of loans by 19%. The consumer surplus decreased by an equivalent of 2.5% of average income, with larger losses for riskier borrowers. In addition, Mohane et al. (2000) assessed the logic of interest rate ceilings on the microfinance market in South Africa and found that the biggest cost component of micro-lenders was administration costs and not the cost of capital, and so linking interest rate ceilings to the prime rate was illogical.

Campion et al. (2010) examined the effect of limiting micro-loan interest rates to the average set by the banking system. The study revealed that MFIs and commercial banks withdrew from rural areas due to high operating costs and risks. MFIs also added fees to circumvent the interest rate cap. Unfortunately, their portfolio growth fell from 30% per year to less than 2% when the interest rate ceiling was introduced (Rosenberg, 2002). Alper et al. (2020) investigated the reason for interest rate capping in Kenya and found that it was to reduce the cost of borrowing and expand access to credit. When the ceiling was introduced in 2015, within a year the amount of credit given to SMEs dropped by almost 10%. Surprisingly, lending to other types of borrowers (such as households or large corporations) continued to increase at a rate similar to the one prevailing before the introduction of the ceiling. Overall, in one year the amount of credit given to the private sector shrank to 2%, while lending to the public sector increased to over 25% (Alper et al., 2020). The percentage of Non-Performing Loans (NPLs) increased by over 8% after the cap was introduced. In contrast to the law, 60% of the interest rates charged on loans was above the cap. Relatedly, Ferrari et al. (2018) reported that, while some forms of interest rate caps can indeed reduce lending rates and help to limit the predatory practices of formal lenders, interest rate caps often have substantial unintended side-effects. Consequently, Kenya lifted theirs in 2019.

A recent study by Heng et al. (2021) in Cambodia found that, despite their objective of broadening financial inclusion through interest rate ceilings, it had an undesirable effect. An interest rate ceiling of 18% was enforced on loans offered by MFIs in 2017. After the cap was introduced, MFIs began to charge higher non-interest rate fees to offset the loss of interest income. Loan-related commission fees tripled, on average, across all MFIs. The number of borrowers declined immediately as MFIs turned away from small borrowers and shifted toward larger ones in urban areas. Likewise, a study by Safavian & Zia (2018) on interest rate caps globally indicated that they increase non-interest fees and commissions, reduce price transparency, lower the supply of credit for small and risky borrowers and have an adverse impact on lenders' profitability. The study showed that following the introduction of interest rate caps, the proliferation of fees reduced the transparency of the cost of credit in Armenia, Nicaragua, South Africa and Zambia. It reduced the diversity of products for low-income households in France and Germany, and reduced competition between banks in Italy. It also increased illegal lending in Japan and the United States. Consequently, several countries took measures to remove interest rate ceilings or change their enforcement. For example, in 2016, the Central Bank of Argentina announced the elimination of all interest rate caps for credit operations, and in 2015, Zambia removed those that had been introduced in 2013. China removed all restrictions on the commercial bank lending rates in 2013.

It is observed that several countries that attempted to introduce interest rate ceilings, particularly a single cap across all types of credit, were compelled to lift them, because they distort the market and prevent financial institutions from offering loans to those at the lower end of the market. They also reduce financial intermediation, as loans provided to SMEs and individuals tend to be riskier and more costly to manage. As access to credit is curtailed, potential borrowers may be forced to turn to informal lenders that charge much higher rates and are not subject to supervision. It reduces transparency as lenders may institute higher non-interest charges, such as fees, to compensate for the lower income obtained from the interest. To overcome this challenge, South Africa, for instance, has seven separate ceilings for mortgages, credit facilities, unsecured credit, development credit, short-term transactions and other incidental credit agreements (Safavian & Zia, 2018).

Overall, the issue of the interest rate ceiling has been given some consideration, although the debate about the logic behind it and the resulting impact is ongoing. However, it is clear that interest rate ceilings are against the principles of the free market, and their justification depends on the degree of competitiveness in the credit market. If the financial market is imperfect, an interest rate ceiling is justified on the grounds of protecting consumers from being exploited by loan sharks. Still, in most countries where interest rate ceilings were introduced, they were withdrawn because of several undesirable effects on financial inclusion and the sustainability of lenders. It might also be due to the fact that caps did not usually take into account the market conditions in which they were applied, although these conditions may significantly affect their resulting outcome (Caballero-Montes et al., 2021). For example, Tanzania's credit market is fairly competitive with over 50 banks and 600 MFIs, let alone finance companies, credit unions and thrift institutions[2]. In this context, consumers can choose from several lenders of a particular institutional type and put pressure on them to lower the interest rate to the optimal level.

Altogether, the previous research on the effects of interest rate ceilings largely substantiates the argument that they lead to a reduction in the amount of credit provided by lenders. While interest rate ceilings determine the price that lenders can charge, they do not constrain the other conditions that lenders may choose to impose. Consequently, when interest ceilings are introduced, lenders rely on other financial means to allocate credit to potential borrowers. As a result, interest rate ceilings may fail to give consumers the protection and benefits they were intended to provide. Therefore, our thinking is that while a ceiling may reduce the explicit price of credit, it may not result in lowering the cost of borrowing, even for those able to obtain loans. In view of this, we support the economic theory, which argues for interest rate deregulation and calls for the adoption of measures to protect consumers that will mitigate the challenges of market imperfection particularly the information asymmetry and adverse selection of clients.

Methodology

This article draws data from a qualitative study conducted in Tanzania from 2021-2022. We chose the qualitative approach as an appropriate way in which to explore the subject, in order to gain a full understanding of the recently introduced interest rate ceiling. We began with the

[2] This is according to statistics published by the Bank of Tanzania (2021).

literature review and identified some research issues that required further investigation. We noted that, although the issue of the interest rate ceiling had been discussed in the policy-related literature, there was little empirical evidence based on rigorous analyses, especially in emerging economies where MFIs are quite young. In our research setting, the interest rate ceiling had just been introduced and, to the best of our knowledge, no similar study had been conducted. In addition to the academic literature reviewed, we collected secondary information from the MFI Acts and Regulations and previous reports so as to identify the provisions that covered the issue of the interest rate ceiling.

The primary data were collected through: i) an online checklist administered to MFIs; ii) compiling the issues raised during a workshop organised by the BOT; iii) compiling the issues raised and suggestions made by members of TAMFI through its social media group; and iv) compiling the written comments and views shared by selected MFIs. The main thematic issues that were relevant to this article focused on the regulatory framework, the profile of MFIs and the perceived effect of the interest rate ceiling.

A checklist of data required for the purpose of this study was sent to all 78 active members of TAMFI, from which the list was obtained. Members of TAMFI were selected because they were formally registered and over 74% of them had been licensed and had begun to comply with the newly introduced interest rate ceiling. A total of 53 respondents (almost 68% of the members of TAMFI) answered the questions included in the online checklist and emailed the answers to the researcher. Findings from the checklist were complemented by face-to-face interviews with 10 MFI practitioners, who were purposefully selected based on their availability to be interviewed. The interviews were semi-structured around the key study themes, and each interview took about 45 minutes. The interviews were recorded and notes were taken to obtain some thoughts and ideas for analysis.

After recording the data and the views of respondents, they were reviewed to ensure their quality and accuracy. Then, validation of the data was done through triangulating the sources, comprising the data drawn from the online checklists, face-to-face interviews and circulating the draft report to respondents for review, corrections and suggestions.

The data collected were summarised using descriptive statistics to show the profile of the MFIs studied, and the qualitative data were analysed using content analysis. In line with Ryan & Bernard's (2003) suggestion, the researcher integrated the information collected from various documents with the data generated from interviews to establish the challenges of an interest ceiling and the impact of coping strategies adopted by MFIs. A draft research report was presented at a TAMFI stakeholders' workshop, which was attended by 48 participants. Additional views collected from the workshop were integrated into the report. Although a large amount of data were collected, the findings presented in this article focus on the issues of interest.

Findings

Legal and Regulatory Framework Governing MFIs in Tanzania

The MFI sub-sector is governed by the Microfinance Policy and various laws and regulations that are directly or indirectly directed at MFIs. It is observed that policy interventions that

aim to promote the microfinance sub-sector began in 2000, when the Government formulated the National Microfinance Policy (URT 2000), with the view of establishing the basis for the evolution of an efficient and effective microfinance system in the country. In 2017, the Microfinance Policy was reviewed to address the limitations and challenges in the microfinance sub-sector that were observed when the policy was implemented. Some of the limitations are: limited products and services offered by MFIs; high level of financial exclusion; inadequate working capital; weak capacity of MFIs; the absence of a consumer protection mechanism; and the lack of a central register of loans.

The revised Microfinance Policy (URT, 2017) aims to address the challenges of the sub-sector and promote financial inclusion by creating an environment that will enable the microfinance sub-sector to be efficient and effective. In line with this, the policy recognises microfinance as a sub-sector that involves a diversity of institutions which apply various service delivery methodologies. It recognises that MFIs charge higher interest rates than banks, based on the costs of obtaining capital, personnel and loan loss. The policy also recognises that no system of calculating interest rates is applicable to all MFIs and companies. The interest rates applied are differentiated by product, product attributes and features, comprising loan type, amount and duration. Besides the interest rates, the policy recognises other issues, including unfair provisions in loan agreements, inadequate disclosure of lending terms and conditions, and unfair loan collection and recovery procedures. In view of this, the policy stipulates that regulating and supervising MFIs is an integral part of a strategy to develop a market-based microfinance sub-sector[3].

The primary law that governs the microfinance sub-sector is the Microfinance Act 2018, which provides for the licensing, regulation and supervision of microfinance businesses, and makes provisions for related matters. It clarifies the framework under which microfinance businesses and other financial groups operate, and are governed and regulated. It classifies MFIs as: Tier 1 (deposit-taking microfinance service providers, namely banks and microfinance banks; Tier 2 (non-deposit-taking microfinance service providers); Tier 3 (Savings and Credit Cooperatives - SACCOs); and Tier 4 (community financial groups, individual money lenders and community-based organisations). With respect to consumer protection, the Act stipulates that MFIs must comply with the principles in Section 50 that apply to consumer protection, including fairness, transparency and disclosure of information.

Relatedly, the Microfinance (Non-Deposit-Taking Microfinance Provider) Regulations (2019) stipulate that microfinance service providers must ensure transparency and full disclosure of their products and services, by ensuring that the loan agreement contains terms and conditions that are transparent and fair and protect the rights of the borrower. It is worth noting that, although both the Act and Regulations do not contain any provision for setting an interest rate ceiling. A further review of related Regulations reveals the same observation. For instance, the Bank of Tanzania (Consumer Protection) Regulations (2019) provide for free market practices in the banking sector. For example, section 40 (2) states that a financial service provider: shall not charge consumers fees that have not been previously disclosed; and shall publish and display interest rates, fees and charges and other related costs in a

[3]Section 3.1.3 pg.30 of the Policy

conspicuous place in its business premises. Likewise, the Fair Competition Act (2003) does provide for a price ceiling, whether for non-financial or financial services.

A number of observations are made from the legal and regulatory framework as follows. First, the MFP-2017 recognises that microfinance involves a diversity of institutions that apply various service delivery methodologies. This suggests that MFIs are not homogeneous, and treating them equally in price setting may impact some of them more adversely. Accordingly, interest rates are differentiated by product, product features and associated risks, which for the sake of promoting innovation should not be standardised. Second, while the Microfinance Act 2018 and the Microfinance (Non-Deposit-Taking Microfinance Provider) Regulations (2019) provide for consumers' protection, they do not set an interest rate ceiling. Instead, they encourage transparency and disclosure of information. Third, the Bank of Tanzania (Consumer Protection) Regulations (2019) encourage free market practices as the basis on which to develop a wide range of innovative financial products and services. This implies that, if MFIs are enabled to adopt consumer protection practices, they will become more efficient and charge competitive interest rates on their services. Consequently, the BOT is enforcing the Second National Financial Inclusion Framework (NFIF 2018-2022)[4] to ensure consumer protection is achieved by empowering borrowers to notice exploitative loan conditions and keep away from predatory lending.

Profile of MFIs and the nature of their operations

The findings reveal that over 45% of MFIs were established five years ago and less than 25% were established before 2010 (Figure I). This shows that a good number of them were relatively new. The majority had less than five branches and were registered as companies limited by shares. Implicitly, the sub-sector was greatly funded by private capital. However, 74% of the MFIs studied had already acquired a licence, while the rest had submitted their applications and were awaiting a decision by the BOT. Actually, most MFIs (98%) were in Tier 2, the majority of which (79%) were based in Dar es Salaam. This reflects the distribution of other businesses, most of which are found in Dar es Salaam, the foremost commercial city in the country (Charles, 2014).

The size of loans offered by MFIs varied significantly, ranging from TZS 50,000/= to over 10,000,000/[5]= (Table I), although the majority (over 80%) offered small loans ranging from 50,000/= to 500,000/=. The highest amount offered varied from TZS 200,000/= to over 100,000,000/=, while some offered between TZS 1,000,000/= and 50,000,000/=. This shows that MFIs were not homogenous in terms of their lending capacity and target market.

[4] The Bank of Tanzania Annual Report (2019/20)

[5] $1= TZS 2,300/= as per Bank of Tanzania exchange rate

Figure I: Profile of MFIs studied

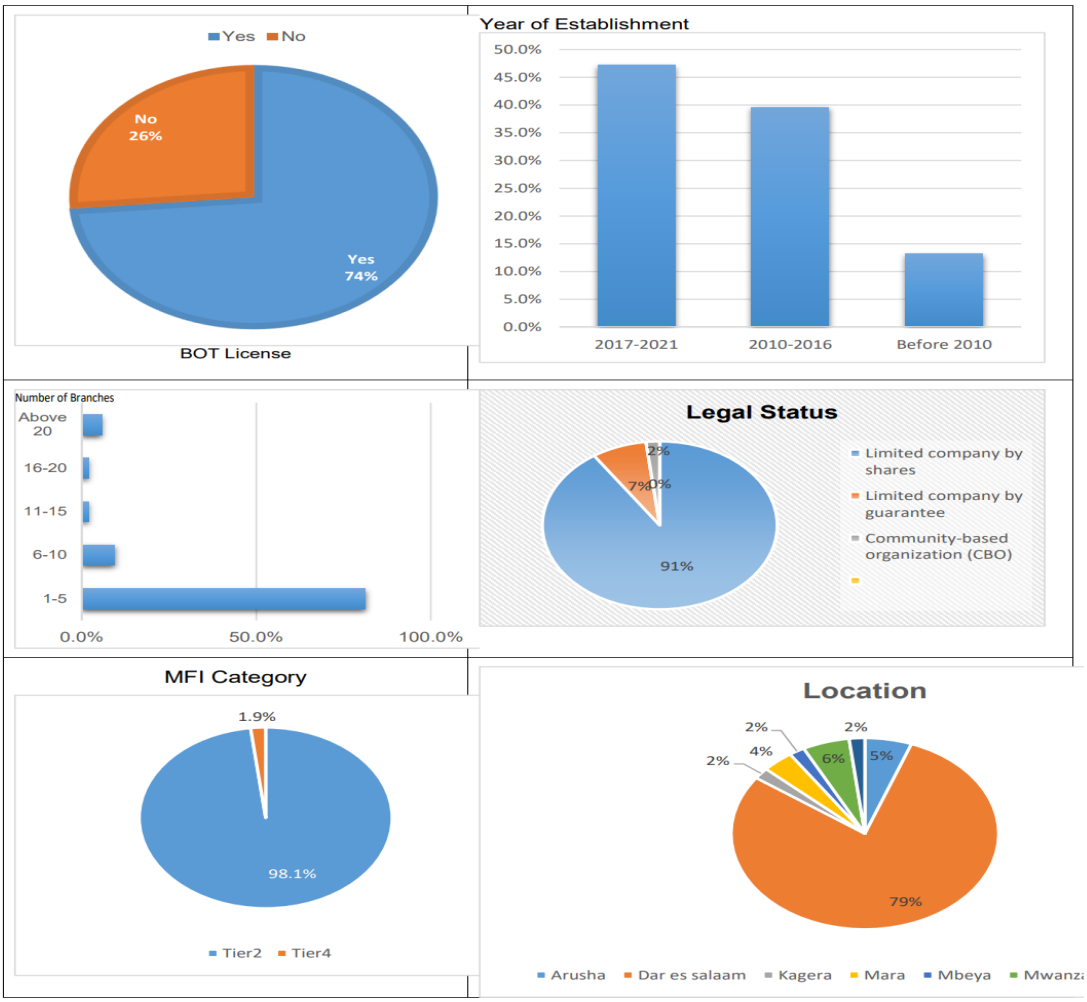


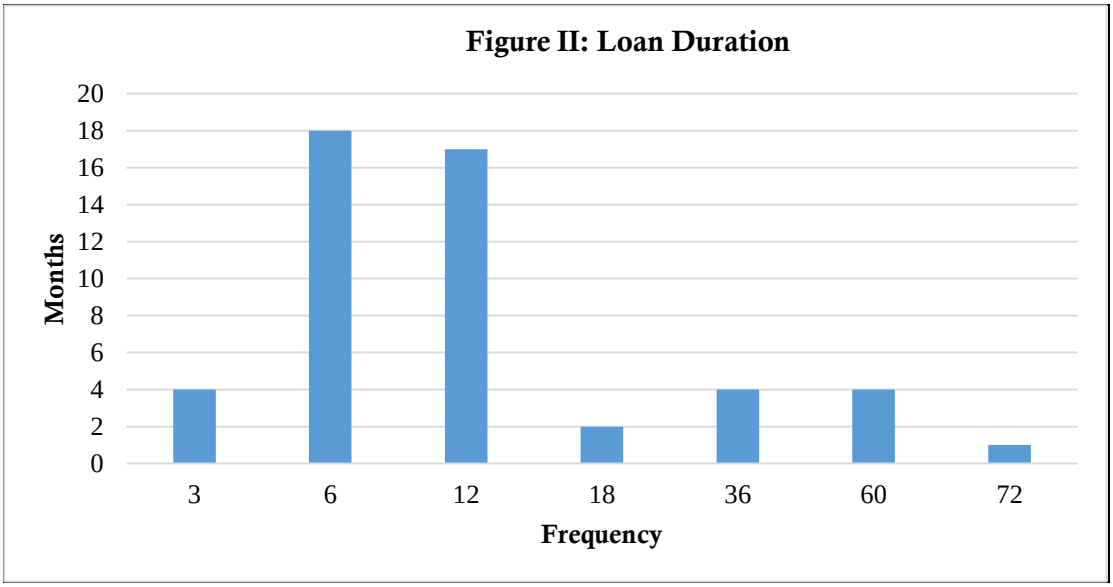
Table I: Minimum and Maximum Loans by MFIs

Minimum Loan Size (TZS)	Frequency	%	Maximum Loan Size (TZS)	Frequency	%
50,000-100,000	20	38.5	200,000-1,000,000	2	4.0
100,001-250,000	11	21.2	1,000,001-5,000,000	14	28.0
250,001-500,000	13	25.0	5,000,001-20,000,000	15	30.0
500,001-1,000,000	3	5.8	20,000,001-50,000,000	13	26.0
1,000,001-10,000,000	3	5.8	50,000,001-100,000,00	4	8.0
Above 10,000,000	2	3.8	Above 100,000,000	4	8.0
Total	**52**	**100.0**	**Total**	**52**	**100**

In terms of loan duration, most MFIs offered loans that lasted for 6 to 12 months, while very few provided loans that lasted for 72 months (Figure II). Actually, the majority of them provided short-term loans, ranging from two weeks to one year. Over 60% of the loans were

given to SMEs and the rest to employees and individual borrowers. However, there were exceptional cases of MFIs providing loans to established businesses that had failed to obtain a bank loan within a reasonable time. This shows that MFIs were exposed to greater risk as they served clients who did not qualify for bank loans. It can be seen that the majority of them served clients who were unable to provide appropriate collateral for obtaining a loan with a more simplified documentation process and credit risk analysis. Analysis of the feedback from MFIs shows that only 7% of their clients provided title deeds as collateral, while over 35% were unable to offer any form of collateral, and the rest provided goods and chattels. In view of this, the risk taken by MFIs was much higher than that of banks or institutions whose loans were covered by collateral (real estate, bank guarantees or term deposits).

Figure II: Loan Duration



Evidence from the data collected from MFIs shows that 40% borrowed working capital from banks, 28% from owners' equity and the rest from donors (2%) and the injection of foreign and local capital (7%). Out of 34 MFIs that had borrowed working capital, 9% had loans ranging from 1m to 20m (Table II), around 15% had loans of 100m or less, 21% had loans ranging from 101m to 200m, and 38% had loans ranging from 201 to 500m. Some MFIs were more indebted, with loans ranging from 501 to 1 billion (12%) and over 1 billion (17%). Most loans ranged from 6 months to 72 months and were secured by motor vehicles and title deeds. A few of them (2%) borrowed working capital from other MFIs at a rate of 10% per month, 4% borrowed at 3.5%, and 4% borrowed at the rate of 3% to 3.2%.

Another critical observation was that most MFIs had a high rate of NPLs, mainly attributed to the risks associated with the types of loans they offered. Interviews with MFIs revealed that their NPLs ranged from 10% to 25%. Comparative data obtained from the BOT indicated a similar challenge in the entire sector. For instance, the BOT Annual Report (2018/19) showed that the overall ratio of banks' NPLs to gross loans was 10.7% at the end of June 2019 and 10.3% in 2018, which was above the ceiling set at 5%. The ratio of NPLs to gross loans at the end of June 2020 was still above the 5.0% ceiling, averaging 10.8%.

Table II: Borrowed Working Capital

Millions (TZS)	Frequency	Percent
1-20	3	8.8
21-40	3	8.8
41-100	5	14.7
101-200	7	20.6
201-500	6	17.6
501 - 1 000	4	11.8
1100- 2000	3	8.8
Over 20000	3	8.8
Total	**34**	**100.0**

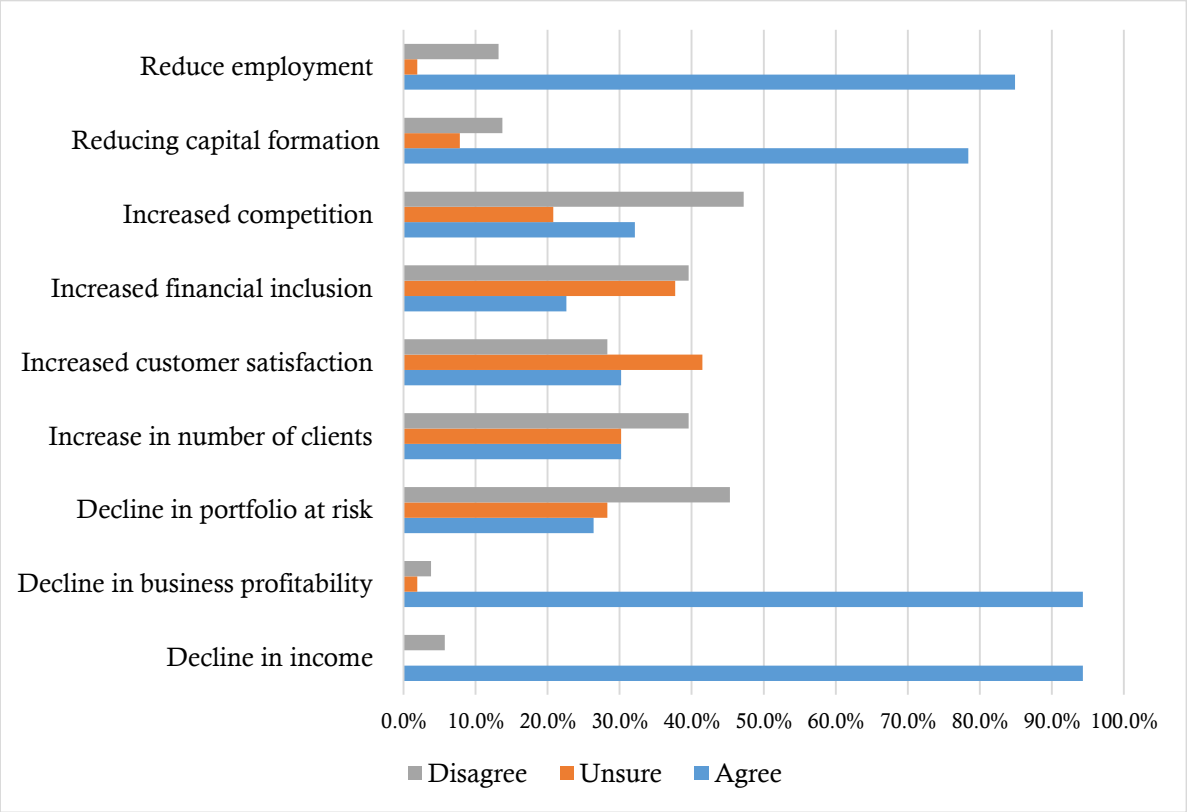
With respect to their annual administrative expenses, the MFIs reported that those expenses comprised over 40% of their revenue, and included all recurrent costs except the cost of obtaining funds, and loan losses. It was further reported that staffing costs alone varied from 19% to 30%, while the proportion of total administrative expenses to operating income varied from 50% to 62%, which was almost as efficient as the leading banks in the country. For instance, the Annual Report of CRDB Bank (2019) indicates that the proportion of operating expenses to operating income was 64.4% and 66.7% in 2019 and 2018, respectively, while NMB Bank's Report shows that the proportion was 59% and 60% in 2018 and 2019, respectively. In fact, the published quarterly and annual reports of most banks in Tanzania indicate that the proportion varied from 59% to over 100%.

MFIs' Views on the likely effects of the interest rate ceiling

MFIs expressed their views on the likely impact of the interest rate ceiling. Based on what they reported, 95% would experience a significant decline in income and business profitability. The interviewed MFIs reported that they would close their business if the interest rate ceiling would be enforced. *The microfinance sub-sector in Tanzania will close down and low-income people will be excluded from obtaining financial services,* reported one respondent. *This will affect the affect the sustainability of MFIs as most of them will not survive,* he added.

Given that most MFIs employ qualified staff, they tend to have high administrative costs, and the interest rate charged is the major sources of income they rely on to cover those costs. Thus, in as much most MFIs used to provide loans at the rate of 5% to 6% per month to meet their operating costs, at least 85% and 78% of them would reduce the number of employees, if the newly introduced interest rate ceiling would be fully enforced. A decision to downscale the business would definitely be associated with a reduction in capital formation, as reported by over 78% of the respondents (Figure III).

Figure III: Likely Impact of New Regulation



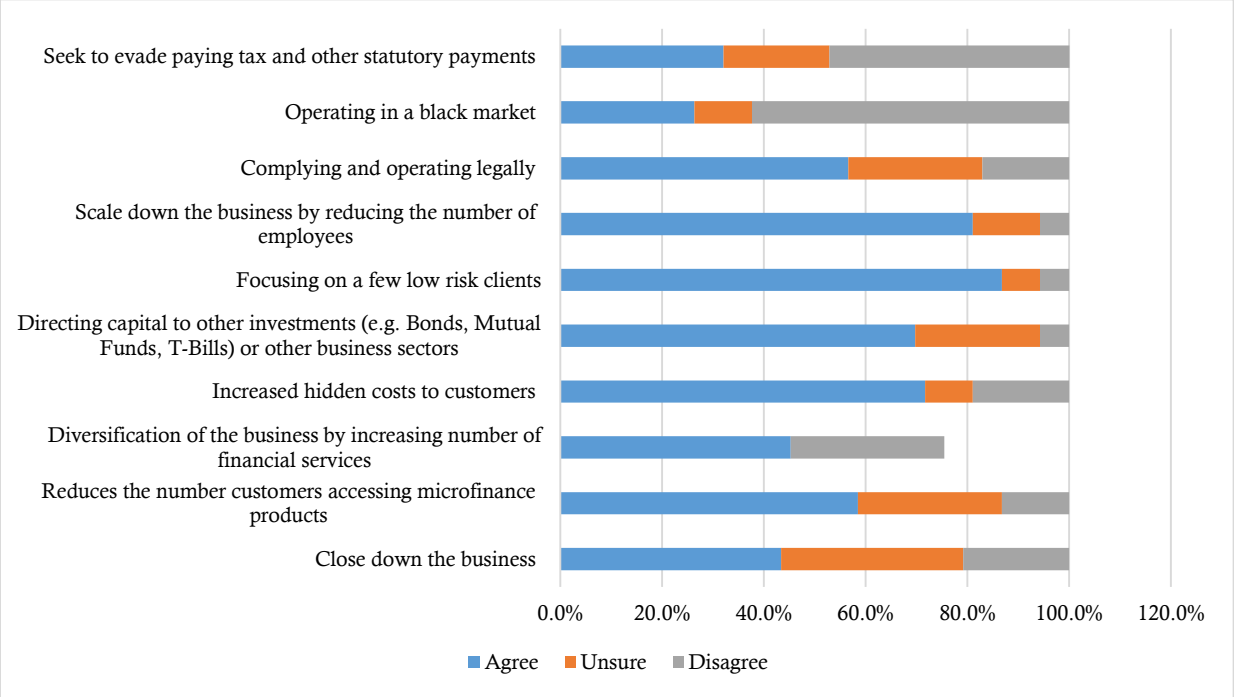
In views of MFIs, if the interest rate ceiling is fully enforced, most of them would not have sufficient funds to cover their costs given that the interest rate charged by MFIs is largely determined by the cost of funds and overhead costs. Table III shows some MFIs' costs accounting for high interest rates. A responded claimed: *the regulator should appreciate the costs incurred by MFIs and allow them price their services accordingly*. Indeed, most MFIs cannot operate with very low interest rates as they operate on a low scale and serve a risky market (Charles & Mori, 2016). While some variables regarding the effect of an interest rate ceiling (increased competition, financial inclusion, customer satisfaction, number of clients and a decrease in portfolio at risk) were rated fairly positively by 22% to 32% of the respondents, the rest reported that it would have a negative impact due to high costs of lending.

Furthermore, MFIs described their coping strategies if the BOT did not lift the interest rate ceiling, most of which are likely to be detrimental to their sustainability[6]. For instance, over 92% of MFIs would focus on a few low-risk clients and scale down by reducing the number of employees (Figure IV). Around 70% would direct capital to other safer investments and increase hidden costs to customers. While over 58% would reduce the number of clients, almost 42% would close their business. About 35% would seek to evade paying taxes while 45% would diversify their business no non-financial entities. It was also observed that over 28% of MFIs would operate in the black market. It is also worth noting that the key impacts of their coping strategies would be to: reduce the number employed in the industry, which is

[6] One institution was allowed to report more than one strategy

likely to impact the general employment level; close businesses; divert resources to other businesses; divert loans to less risky sectors; and possibly raise the level of malpractice in the sector in terms of hidden costs, and dealing in the black market. One respondent said: *most MFIs have already started to explore other businesses and mechanisms of evading taxes as a strategy coping with the new interest regime.* This shows that some MFIs were likely to diversify to other businesses and evade taxes following the imposition of the interest ceiling.

Figure IV: MFI Strategies for Coping with the Interest Rate Ceiling



Discussion

This article presents the findings which show the effects of an interest rate ceiling on the sustainability of MFIs. Overall, it is evident that while the interest rate ceiling is seen as a way of protecting consumers from exploitative lenders, (Ochien & Odondo, 2018), it is often challenged on the grounds of interfering with market forces and increasing financial exclusion, especially of the poor (Maimbo & Henriquez Gallegos, 2014). In line with the economic theory it is observed that when there is competition amongst financial institutions, they will be forced to increase efficiency and reduce the interest charged (Campion et al., 2010). Accordingly, the government of Tanzania introduced the Microfinance Finance Policy, and specific Acts and Regulations to facilitate the registration and formalisation of MFIs. However, while the legal framework provides for consumers' protection, it does not stipulate an interest rate ceiling. Instead, it provides for a mechanism to protect consumers through transparency, disclosure of information and fair business practice. This suggests that alternatives measures to interest rate caps should be considered, which comprise fostering competition, and reducing overhead costs and the cost of obtaining funds.

Overall, the introduction of a ceiling for Tier 2 MFIs is perceived as not only against the spirit of the legal framework and discriminative, but it also goes against the principles of the free

market economy. Although the underlying argument is that the MFI market in Tanzania is not competitive enough to ensure that consumers are not exploited by service providers, the ceiling introduced targeted only MFIs registered under Tier 2, leaving out all other players. A single, blanket cap that assumes borrowers from MFIs in Tier 2 are homogeneous does not allow for price differentiation based on the characteristics of the lender or borrower. As observed in other countries (Heng et al., 2021), such interventions lead to credit diversion, hidden non-interest charges and the poor performance of lenders. In fact, it affects the distribution of credit, as it results in a decline in the number of unsecured and small loans, leading to less focus on high-risk borrowers.

Our findings reveal that MFIs are not homogeneous, as they vary in size, type, the terms and conditions of the loan products offered and their business model. This variation encourages the diversity of MFI services (Charles & Mori, 2017). Thus, standardising the interest rate for all types of loan products and institutions is likely to reduce the diversity needed and increase financial exclusion especially to risky clients who cannot secure their loans (Ochien & Odondo, 2018). Surprisingly, during the interviews it was noted that some banks were charging higher interest rates (up to 5% per month) than the stipulated ceiling for MFIs for bridging loans[7]. Ideally, the repayment period for bridging loans varies from two weeks to a maximum of one year (Charles & Mori, 2016), thereby targeting low-income earners who are financially underserved and rejected by mainstream financial service providers, especially banks, due to the high risks associated with them (Charles & Mori, 2017). The danger of an interest rate ceiling is that it can lead to reallocating loans from those borrowers to large commercial borrowers, who are less risky and cheaper to administer.

It is evident that most MFIs were established quite recently and provided short-term loans to SMEs, employees and individual borrowers. Their opposition to the interest rate ceiling was that the size of their loan varied, as well as their operational capacity, customer segment, operational costs and risk factors. In addition, most clients were unable to offer any form of collateral, although a few provided goods and chattels. MFIs took out bank loans and private equity, which attract high interest rates. The scale of operations of most MFIs was too small to enable them to be sustainable under the newly introduced price structure. Unlike banks that disburse mostly large loans to well-documented customers with viable collateral, MFIs deal with low-income individuals and SMEs that lack proper documentation and viable collateral exposing MFIs to a higher risk. These findings are similar to what is reported elsewhere (e.g.Alper et al., 2020; Caballero-Montes et al., 2021).

Although some respondents pointed out positive aspects of an interest rate ceiling as regards financial inclusion, customer satisfaction, number of clients and a decrease in portfolio at risk, the majority felt that the overall impact on their sustainability was negative, simply because some coping strategies adopted by MFIs had more negative implications. Such strategies entailed focusing on a few low-risk clients, scaling down by reducing the number of employees, investing their capital in safer enterprises while leaving out their target markets, increasing hidden costs to customers and closing their businesses. Other coping strategies that were likely to impact them negatively were evading taxes, diversifying to other forms of

[7]Identity of those Banks is withheld for business reasons.

business and operating in the black market. As reported in other studies, an interest rate ceiling may contribute to the emergence of informal lenders, the withdrawal of services from costly rural areas and risky sectors, which can have a negative effect sustainability of MFIs and financial inclusion. Other risks include bundling some products, and requiring borrowers to buy costly additional services such as insurance, application forms, etc.

Conclusion and implications

Although there are undoubtedly failures in credit markets, which the government has a role in managing, the interest rate ceiling is ultimately an inefficient way of reaching the goal of lowering long-term interest rates. Because interest rate ceilings lead to a significant decline in lending and a change in terms of moving from lending to SMEs to safer markets, it often has unintended side-effects. In view of this, our article supports the view stipulated by the economic theory that a competitive market can prevent lenders from exercising power over pricing or earning more than a normal return (Donna, 1982). However, in a market where there is not enough competition to ensure competitive interest rates, enforcement of consumer protection measures can ensure that consumers are not exploited by unscrupulous lenders. A move to encourage formalisation of MFIs rather imposing an interest ceiling, could be the best way to ensure competitive interest rates. The corollary of this would seem to be that governments should license more financial institutions to promote competition and drive down rates, while protecting consumers based on non-interest measures.

In line with good practice, policy interventions should promote consumer protection principles stipulated in the legal framework, including transparency and free market principles. In addition, MFIs should be facilitated to access affordable capital through low-cost funding opportunities. The BOT should focus on policy interventions aimed at fostering competition by licensing more MFIs. Enforcing the disclosure and transparency of MFIs' prices would enable clients to have full information about the cost of loans and make informed decisions. It is therefore concluded that there are more effective ways of reducing interest rates on loans in the long run such as measures that enhance competition, improve consumer protection, enforce disclosure of interest rates, and promote microcredit products.

The qualitative findings presented in this article cannot be generalised given that they are based on a cross-sectional study of a sub-sector that is still young. Perhaps a longitudinal study to analyse the situation after full adoption of the interest rate ceiling would generate more advanced findings to inform the current debate. The inclusion of banks and other financial institutions would improve the rigour and generalisability of the findings. One interesting topic could be comparing operational costs of banks and MFIs operating in developing countries. In addition, a study is needed to establish the extent to which an interest rate ceiling discourages MFIs from formalising and expanding the informal market, which in turn promotes expensive lenders and loan sharks.

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