

Prakas on the Calculation of Interest Rate on Microfinance Loans

Since 2001, the use of the flat interest rate calculation method on microfinance loan products has been prohibited in Cambodia through the National Bank of Cambodia's *Prakas on the Calculation of Interest Rate on Microfinance Loans*. As a result of this legislation, all microfinance institutions (MFIs) in Cambodia charge interest on the declining balance of the loan amount.

Background

The National Bank of Cambodia (NBC) has historically been focused on client protection in the microfinance industry. Through a range of approaches, they have consistently worked to lower interest rates on microloans with the goal of improved financial services for the poor. Making use of past experience and research, the NBC determined that it was not in favor of imposing a price cap due to the associated risk of limiting access to credit for the poorest borrowers. Instead, the NBC aims to create a conducive environment for fair competition among MFIs in order to facilitate a decline in prices and improvement in services through market forces.

The NBC decided that one of the most effective ways to facilitate competition was through pricing transparency, specifically by standardizing the method of calculating prices. Prior to government intervention, MFIs used the declining balance interest rate calculation for some products and the flat method for others. This can make comparison between the prices of loans difficult, posing a serious obstacle to MFIs in terms of their ability to make informed price-setting decisions and to clients in terms of comparing the prices of the loan products available to them.

To address this market imperfection, in 2001 the NBC announced the *Prakas on the Calculation of Interest Rate on Microfinance Loans* as its first guideline on pricing calculation specifically targeted to MFIs. This policy made use of the declining balance method of calculating interest rates compulsory for all MFIs.

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The *Prakas on the Calculation of Interest Rate on Microfinance Loans* set an important guideline for the practice of transparent pricing. Article 2 of the Prakas mandates the use of the declining balance method of calculating interest rates. Banks, licensed MFIs, registered and unregistered NGOs, and mutual savings and credit associations are all subject to this set of regulations.

For the NBC, this policy achieved two objectives:

1. It drastically improved the environment for competition among MFIs in Cambodia. In a transparent market institutions can begin to set prices based on those of their competitors, ultimately leading to more efficient pricing and in an overall decline in costs for borrowers.
2. The Prakas was also an important first step toward improved consumer protection, enabling microfinance clients to both act as informed consumers as well as benefit from the decline in prices that resulted from the policy.

MFTransparency highlights the Prakas as a simple but effective pricing disclosure policy solution. The full text of this important policy can be read on the following page.

PRAKAS

On

The Calculation of Interest Rate on Microfinance Loans



Article 1

Rural credit specialized banks, Micro Finance Institutions registered and licensed from the National Bank of Cambodia, Non-governmental organizations (NGOs), associations, under the law on Banking and Financial Institution shall calculate interest rate to comply with the provision of this Prakas with regard to their credit operations.

Article 2

Interest charged on any loan granted by an entity mentioned in **Article 1**, must be calculated taking into account the repayments of principal already made on that loan. Consequently, interest charged on a loan for a given period (week, month, quarter, year as the case may be) shall be calculated on the loan outstanding balance at the end of that period.

Article 3

Loan agreement between Micro Financial Institutions and customers shall have credit amortization table.

Article 4

Covered entities that contravene to the provisions of this Prakas will be subject to the disciplinary sanctions mentioned in Article 52 of the Law on Banking and Financial Institutions.

Article 5

All provisions contrary to those of the Prakas are hereby repealed.

Article 6

The General Direction, the General Secretariat, the General Inspection, the General Cashier, all Departments of the National Bank of Cambodia, and all Banking and Financial Institutions under of the National Bank of Cambodia supervisory authority shall strictly implement this Prakas.

Article 7

This Prakas shall have effect from the signing date.

Phnom Penh, August 14, 2001

Governor

Signed and sealed: **CHEA CHANTO**