

Outlawing Flat Interest in Cambodia

Since 2001, the use of the flat interest rate calculation method on microfinance loan products has been prohibited in Cambodia. As a result of the implementation of the National Bank of Cambodia's *Prakas on the Calculation of Interest Rate on Microfinance Loans*, all MFIs in Cambodia charge interest on the declining balance of the loan amount. This case study will highlight the regulatory decision of outlawing the flat interest rate calculation method and discuss the impact of this approach on pricing transparency in the Cambodian microfinance market.

Introduction

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.

Through the declining, or reducing, balance interest rate calculation method, the lender charges interest on the loan balance that the borrower has not yet repaid. This amount declines over time as the borrower repays the loan, so that interest is only charged on money that the borrower is in possession of. Through the flat balance calculation method, the interest rate is applied to the initial loan amount throughout the entire loan term. Through this method the borrower pays interest on the full loan amount even though the amount they have over the loan term is less and less as they repay the loan. Interest rates calculated using the flat balance appear much cheaper than declining balance rates, but are in fact nearly twice as expensive. For example, an annual interest rate of 15% charged on a flat balance results in almost the same amount in interest payments as an annual interest rate of 30% charged on a declining balance. 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.ⁱ

Prakas on the Calculation of Interest Rate on Microfinance Loans

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* specifies that the interest rate on any microfinance loan "must be calculated taking into account the repayments of principal already made

on that loan. Consequently, the interest rate charged on a loan for a given period shall be calculated on the loan outstanding balance at the end of that period.” In other words, this 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.ⁱⁱ

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.ⁱⁱⁱ
2. The Prakas was also an important first step toward improved consumer protection^{iv}, enabling microfinance clients to both act as informed consumers as well as benefit from the decline in prices that resulted from the policy.^v

Impact on Pricing Transparency

According to the Social Performance Standards Reports done by the MIX Market in 2008 and 2009^{vi}, all Cambodian MFIs surveyed stated their prices using the declining balance method.¹ This indicates a widespread adoption of transparent pricing practices due to the conducive environment set by the policy of the NBC.

The *Prakas on the Calculation of Interest Rate on Microfinance Loans* is also partly responsible for the decline in prices that the Cambodian microfinance industry has experienced in recent years.^{vii} From 2005 to 2009, the average monthly interest rate on microloans decreased from 3.38% to 2.99% for KHR loans and from 2.71% to 2.26% for USD loans.^{viii} While other factors have also played a role in lowering rates (such as physical infrastructure development, improved efficiency, internal management improvement and the availability of lower-cost funding), a portion of this decline is attributable to the Prakas’ overall impact on pricing transparency and competition in the Cambodian microfinance industry.

Average Monthly Lending Interest Rate				
Currency	2005	2006	2007	2008
Riel	3.38%	3.36%	3.23%	3.20%
USD	2.71%	2.62%	2.34%	2.43%
Others	3.16%	3.13%	3.13%	3.13%

SOURCE: Cambodia Microfinance Development and Challenges

Data collected through MFTransparency’s *Transparent Pricing Initiative in Cambodia* also provides evidence that disclosure of pricing to clients is more transparent relative to many other microfinance markets internationally. The repayment schedule below, submitted by AMK (AMK - Angkor microheranhvatho Kampuchea), clearly states the interest rate for this loan, on a declining balance basis, as well as the term (annual). Other terms are also included, such as the repayment frequency and total cost of credit, and there is a column for ongoing fees in the repayment schedule although there are none in this case.

¹ These MFIS are AMK, CBIRD, Chamroeun, Maxima, SAMIC, TPC and VFC. As of March 2010, these seven MFIs account for almost 50% of the market share by number of active borrowers and around 25% of market share by gross loan portfolio. (MIX Market)

AMK Sample Repayment Schedule

Angkor Mikroheranhvatho (Kampuchea) Co., Ltd. #442, Street 193, Sangkat Tuol Svayprey I, Khan Chamkarmorn, Phnom Penh, PO Box 480, Cambodia Tel. 023 993 062 Fax. 023 221 650 Email info@amkcambodia.com Web www.amkcambodia.com Date: 08/11/2010						
Account Number	[REDACTED]					
Loan Amount	KHR,600,000					
Issue Date	22/10/2010		Interest Rate	42.57 % APR		
Payment Frequency	Monthly		Loan Term	12 Month		
Loan Repayment Schedule						
Page 1 of 1						
Number	Repayment Date	Total Repayment	Fee	Interest	Loan	Balance
1	10 November 2010	11,400	0	11,400.00	0	600,000
2	13 December 2010	19,800	0	19,800.00	0	600,000
Year 2010 Totals:		31,200	0	31,200	0	
3	10 January 2011	16,800	0	16,800.00	0	600,000
4	10 February 2011	18,600	0	18,600.00	0	600,000
5	10 March 2011	16,800	0	16,800.00	0	600,000
6	11 April 2011	19,200	0	19,200.00	0	600,000
7	10 May 2011	17,400	0	17,400.00	0	600,000
8	10 June 2011	18,600	0	18,600.00	0	600,000
9	11 July 2011	18,600	0	18,600.00	0	600,000
10	10 August 2011	18,000	0	18,000.00	0	600,000
11	12 September 2011	19,800	0	19,800.00	0	600,000
12	10 October 2011	616,800	0	16,800.00	600,000	0
Year 2011 Totals:		790,600	0	180,600	600,000	
		KHR 811,800	KHR 0	KHR 211,800.00	KHR 600,000	
End of Report						

SOURCE: MFTransparency

There is additional that could be added to this repayment schedule. This borrower was charged an administrative fee at disbursement, which should be stated here. In addition, the interest rate is labeled “APR” but this is should be defined with a formula that states which charges are included in the calculation.

Similarly, the following sample from Hattha Kaksekar Limited is clear and organized. The interest rate is labeled prominently. The dates and amounts of each installment are also clearly stated, with variations in the date explained. Some practices not explicitly required in the policy framework are nonetheless in place, potentially encouraged by the general environment of transparency and competition created by the Prakas².

² Both of these samples have been highlighted for the purpose of this case study, but it should be noted that many others in the MFTransparency dataset are written in the local language, generally considered best practice among populations where understanding of a non-local language is limited.

Hattha Kaksekar Limited Sample Repayment Schedule

gtz		Hattha Kaksekar Limited		10-11-2010		
		Siem Reap Branch - 004		9:12 AM		
		31-10-2010		Page: 1 of 1		
Loan Schedule Report						
Name:	[REDACTED]	Account Number:	[REDACTED]	Approved:	600.00	
CID:	[REDACTED]	Opened:	27-10-2010	Disbursed:	600.00	
Address:	[REDACTED]	First Installment:	05-12-2010	Balance:	600.00	
		Maturity:	05-02-2012	Principal Due:	0.00	
		Interest Rate:	34.80 %	Interest Due:	0.00	
		Disbursement Date:	27-10-2010	Status:	Disbursed	

No.	Due Date	Balance B/F	Principal	Interest	Total	Balance C/F
		<u>Installments Not Yet Due</u>			<u>Prepaid</u>	
1	06-12-2010*	600.00	40.00	22.62	62.62	560.00
2	05-01-2011	560.00	40.00	16.78	56.78	520.00
3	07-02-2011*	520.00	40.00	15.58	55.58	480.00
4	07-03-2011*	480.00	40.00	12.99	52.99	440.00
5	05-04-2011	440.00	40.00	13.19	53.19	400.00
6	05-05-2011	400.00	40.00	11.60	51.60	360.00
7	06-06-2011*	360.00	40.00	10.79	50.79	320.00
8	05-07-2011	320.00	40.00	9.28	49.28	280.00
9	05-08-2011	280.00	40.00	8.39	48.39	240.00
10	05-09-2011	240.00	40.00	7.19	47.19	200.00
11	05-10-2011	200.00	40.00	5.80	45.80	160.00
12	07-11-2011*	160.00	40.00	4.79	44.79	120.00
13	05-12-2011	120.00	40.00	3.48	43.48	80.00
14	05-01-2012	80.00	40.00	2.40	42.40	40.00
15	06-02-2012*	40.00	40.00	1.20	41.20	0.00
			600.00	146.08	746.08	

Installation dates marked with * are shown on the next working date after the due date

SOURCE: MFTransparency

There are several ways that this repayment schedule could be still more communicative as well. For example, the term of the interest rate is not stated (eg monthly? annual?). Though this product does not include fees, it does include a security deposit, which should also be stated on the schedule.

Another important guideline in the Prakas addresses the amortization table. Article 3 mandates that any loan agreement between microfinance institutions and customers shall have a credit amortization table. Although this Article does not specify the format or content for this table, the fact that it is required is an important step toward pricing transparency on its own.^{ix} Stipulations such as this may also account in part for the thorough nature of repayment schedules such as the above samples.

Takeaway Points

Through a policy measure prohibiting the use of the flat interest rate calculation method, the National Bank of Cambodia has created an environment for fair competition within its microfinance market. This policy move was effective for several reasons:

- **It is simple and enforceable.** There is no ambiguity about the practice or intention of the policy, it is relatively easy for MFIs to implement and it is straightforward in terms of monitoring adherence.
- **It supports both service providers and clients.** This is one of the best illustrations of the concept that transparency benefits all stakeholders in the market. With a better understanding of prices in comparison, MFIs can price relative to their competitors and clients can make more informed decisions about their options, as well as benefit from the ultimate decline in prices.
- **It is a concrete step toward additional measures.** This initial step toward transparency lays the groundwork for additional steps in disclosure, as evidenced by the sample repayment schedules, making subsequent developments easier to implement and more readily accepted.

MFTransparency considers the outlawing of flat interest rates to be a model best practice for regulating pricing disclosure in the microfinance industry. It can help facilitate the functioning of free market forces, potentially resulting in benefits such as improved services, increased product diversity and lower prices passed on to the client. Competition in a transparent environment helps ensure that the rights of all stakeholders are protected.

In addition to banning the use of the flat interest rate calculation, *MFTransparency* recommends policy that specifies the disclosure of:

- All fees and charges
- Insurance
- Security deposit requirements
- Effective interest rate, as calculated with an official formula

These are all components of that affect the client's cost of borrowing. Policymakers should require MFIs to make effective rates known, through the use of an official formula, so that the true costs of different loan products are comparable. The fact that Cambodian institutions adhere so well to the requirements of the Prakas suggests that if the National Bank of Cambodia were to require the disclosure of additional pricing information it could potentially have an even greater impact on the practice of transparent pricing in the market. The Prakas sets an excellent foundation for the National Bank of Cambodia, as well as the regulators of other microfinance markets, to build on.

MFTransparency is promoting price transparency by educating stakeholders, promoting standards for disclosure and by publishing the true costs of microfinance products in a clear, consistent fashion. To learn more please visit www.mftransparency.org or contact us at resources@mftransparency.org.

Sources

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