Series 1 - Economic Pillar: Financial Services

Taming Predatory Lending for a Resilient Financial System and Economic Growth

Dr Joy Kiiru

Key Messages

- *Pricing for risk by financial institutions, and charging higher interest rates to more risky borrowers is not necessarily bad for the economy.*
- *A more competitive formal financial system will keep bank interest rates low*
- *Tame predatory lending by imposing regulations that protect poor borrowers*
- *Consider social protection to aid the very poor and vulnerable. Credit/loans may cause more harm to them*

Context

Kenya's credit market has gone a full circle in just about three years. Before 2016, interest rates were to a large extend liberalized, and relatively high to the frustration of policymakers. High interest rates are an obstacle to domestic investments while at the same time they contribute to bank profitability. The fact that banks were very profitable in the context of household and individual indebtness with low returns on savings was perceived as unethical and unacceptable. A group of lawmakers moved a motion that was unanimously passed in parliament in 2016 to introduce interest rate controls2. The objective of the interest rate controls was to reduce the cost of credit, increase or expand access to credit while increasing the returns on savings. However, there is evidence that "the law on interest rate controls obtained the opposite effect. Specifically, it led to a collapse of credit to micro, small, and medium enterprises, as well as individual credit; shrinking of the loan book of the small banks; and reduced financial intermediation" (Alper et al. 2019 p.1). Three years down the line in 2019 the law that provided for interest rate controls was repealed.

The real problem with interest rate controls was the inability for banks to price for risk. As such, government bonds became more attractive to financial institutions as opposed to lending to micro and small enterprises which were perceived as risky despite their crucial role in employment creation, investments and economic growth. The interest rate controls, therefore, created a vacuum where the so-called risky borrowers (firms and individuals alike) had to look for other avenues to access to credit. This policy brief is critical especially in the wake of the 2019 financial access survey that showed that the percentage of people with access to credit services was at 82.9 per cent, up from 26.7 per cent in 2006 and 75.3 per cent in 2016.

The same survey found that financial health (the ability to cope with unexpected financial demands) was worsening. Much of the access to credit is fuelled by a proliferation of lenders using mobile phone technology to give quick small loans with terms that are otherwise unfair to the wellbeing of the borrower. This amounts to predatory lending, a lending practice with unfair or abusive loan terms on a borrower. It also amounts to a coercive practice that convinces a borrower to take a loan that they can do without. In this research, we

Roadside vendors and motorcycle taxis (Photo: Madara Ogot)

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focus on lending systems targeting the poor, to give policy recommendations for a healthy and resilient credit system in Kenya.

Approach

We used data collected through a survey to evaluate sources and impact of financial services to poor households. We utilized both theoretical and empirical econometric modelling methods to analyse the data.

We focus on lending modalities for poor households and entrepreneurs, in particular, solidarity lending and other socially secured loans to demonstrate that the so-called "informal collateral" ideally over-secure loans for the poor and is the genesis of predatory lending.

Results

We present two main arguments derived from our research: One, policymakers should not worry about banks being able to price for risks and to charge “higher” interest rates to more risky borrowers. Moreover, if the banking system is competitive, interest rates will remain relatively low. The alternative to bank credit (be it for enterprises or individuals) include informal money lenders, investments groups (*chamas*), and digital mobile app loans. All these alternatives charge much higher interest rates and or impose unfair terms to the borrower. Our second argument demonstrates that in the Kenyan context, characterized by relatively high poverty levels and income inequalities, the demand for credit (both households and firms) is ripe. Poor people or enterprises seek credit as a matter of survival and easily discount or under-rate the real cost of credit. Their situation pre-disposes them to predatory lenders. Thus there is the need to regulate credit markets to ensure that access to credit not only adds to economic growth but also resilient financial systems.

Our study revealed that 10 per cent of the sample used at least 75 per cent of the loans for immediate consumption needs, another 57 per cent used at least 75 per cent of their loans for productive activity and only 33 per cent used the entire credit for productive activity. Loan repayments consisted of stringent regulations by both borrowers and microfinance institutions. For example, there were weekly meetings to collect all due loans, make loan instalments and mitigate imminent default by any group member. The loan officer would preside over the meetings and would not adjourn till all due loan instalments have been redeemed. In case of imminent threat of default for any outstanding loan instalment, the group officials were responsible. They carry out immediate fundraising including borrowing from informal money lenders just to redeem the group but with consequences to the defaulting member. Sanctions to the defaulter include threats, penalties, social stigma and alienation. Confiscation of private property was also rampant. However, its group members who confiscate each other's property in case of default. Repayment rates by joint liability groups stood well over 90 per cent. The poor are therefore trapped in a situation where default would lead to both economic and social costs. In our sample, only about 20 per cent of the respondents repaid their loan instalments through returns from their enterprises, the rest of the sample experienced distress repayments. Distress repayments include borrowing to repay (62 per cent), sale of pre-existing property (17 per cent) and actual confiscation of private property by group members (4 per cent).

Another important finding from our study is that the so-called better-off poor (not the poorest) are in a better position to benefit from small loans as long as the loans jump-start them into productive activities within their areas of expertise. Finally, the very poor are too poor to benefit from market-driven interventions like microcredit. What the very poor need are non-market interventions like social protection services as a matter of survival. Access to credit will not necessarily turn a poor person into an entrepreneur and hence the need for a realistic policy on access to credit and entrepreneurship to ensure that only viable enterprises or households access credit. The implication is far-reaching especially to mobile phone app-based lending that preys on the youth and other vulnerable persons.

Policy Recommendations

Short-Term

- Regulations that encourage the viable selection of households and entrepreneurs into solidarity borrowing groups should be encouraged. For example, outlawing informal contracts that allow group members to confiscate defaulters' private property.
- Financial resources even though held as security for loans advanced to solidarity groups, should be held in interest-bearing accounts, unlike the current scenario where such accounts bear no interest. “Forced savings" are part of the reason why poor people's loans are over-secured and should be discouraged or made to work for them.
- Consider social protection for the very poor, as they may benefit from market-driven interventions like credit.

Medium-Term

- Banking regulations should ensure a competitive banking system to keep interest rates low.
- Regulate digital lending to create a stable and resilient banking system.

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