Position Paper on Proposed Interest Rate Cap

I. Executive Summary

Interest rate caps could be argued as the most repeated government intervention in financial markets. They are also one of the most controversial and often debated with economic, philosophical and religious perspectives. The most recent relevant research has been undertaken by the World Bank[1].

The World Bank is clear that rate caps are not effective at reducing the overall cost of borrowing and have many unintended side effects. The research shows effective measures to reduce the overall cost of credit and to increase access include measures to foster competition, allow better assessment of risk and reduce fraud, including comprehensive credit bureau infrastructure, national ID schemes and efficient capital and financial markets to reduce the cost of funding for non-bank financial institutions.

The World Bank recognizes there may however be a case for a cap at a significant level above the market clearing price to protect against predatory lending. Such a cap should be narrowly focused on that part of the market which is not functioning efficiently.

Financial inclusion is a major policy objective of most governments and the major argument against rate caps is that they distort the market and prevent access to those at the lower end of the market who have no alternative access to regulated credit. Rate caps drive customers to informal sources of credit, yet borrowers are always better off in a regulated environment.

Interest rate caps come in many different forms. Restrictions used across countries vary substantially regarding what they cover and how they work. Interest rate caps can be based on their scope, number of ceilings, type, methodology, benchmark, whether they are binding and whether they also include fees.

If the policy objective is to prevent excessive interest rates and to protect vulnerable clients from predatory lending practices, then there is evidence that caps set at a level well above market rate can be effective at removing extreme pricing with little impact on the efficient working of the market. The design of any rate cap involves many considerations and poor design can have material negative consequences. The rate cap needs to be targeted to focus on perceived harm.

Many countries have introduced narrow caps focusing on high cost short term lenders or "payday lenders". There is anecdotal evidence of problems in the Philippines from this segment caused by rates well above market clearing levels and behavioral aspects of the borrowing. The recently announced survey should bring clarity to this issue.

There is a global consensus that interest rate caps are an ineffective tool for lowering the overall cost of credit and have many unintended side effects. Blanket caps affect the distribution of credit resulting in a particularly large decline of unsecured and small loans, as well as credit to SMEs and riskier sectors. The Philippines should seek to avoid such a cap, focus on the policy issues which are effective and, once the evidence is available, consider a narrowly targeted high level cap focused on predatory lending by "payday lenders".

[1] Policy Research Working Paper 8398 Interest Rate Caps the Theory and The Practice Aurora Ferrari Oliver Masetti Jiemin Ren Finance, Competitiveness and Innovation Global Practice April 2018 WPS8398.

I. Introduction

This Position Paper is jointly submitted by the Philippine Finance Association ("PFA") and the FinTech Alliance (the "Alliance").

The PFA is the umbrella organization of finance, leasing and lending companies in the Philippines, which aims to serve the credit needs of micro, small and medium enterprises (MSMESs), individuals such as overseas Filipino workers (OFWs), seamen, self-employed individuals, low-income households and the unbanked and underserved who comprise mostly of the disadvantaged sectors..

On the other hand, the Alliance is the umbrella organization of various emergent and innovative companies with a mission to be a catalyst for inclusive and sustainable development and expansion of the digital finance ecosystem in the Philippines. Its members are principally engaged in providing affordable, inclusive, convenient, and secure access to credit, with all the related opportunities and benefits such access entails, to Filipinos who typically cannot secure loans from banks and traditional credit-granting institutions.

Interest rate caps could be argued as the most repeated straightforward government intervention in financial markets. They are also one of the most controversial and often debated with economic, philosophical and religious perspectives. The most recent relevant work has been undertaken by the World Bank[2].

The World Bank study concludes that "In light of the possible unintended consequences of interest caps, alternatives and complementary measures to interest rate caps should also be considered. These include measures to foster competition, reduce risk perception, overhead costs, and cost of funds. Consumer protection and financial literacy measures are also important measures, especially if interest rates are meant to protect consumers from usury rates."

As discussed in our previous position papers, the imposition of interest rate ceilings, as underscored by numerous studies[3], demonstrates that the burden of interest rate ceilings falls most heavily on borrowers whose credit standing is weakest and who are deemed most high risk. Caps thus pose a substantial threat to financial inclusion, access, and choice. If the legal limit restricts the price of credit to a prescribed maximum that may be below the market rates of responsible lenders, it may effectively reduce available credit, not only by inducing lenders to impose more stringent qualification requirements on borrowers to hedge against default, but also by restricting competition and reducing the number of responsible lenders in the market.

Several studies even indicate that interest rate caps rise the average cost of borrowing for those still able to access credit as rates migrate towards the ceiling.[4]

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[2] Policy Research Working Paper 8398 Interest Rate Caps the Theory and The Practice Aurora Ferrari Oliver Masetti Jiemin Ren Finance, Competitiveness and Innovation Global Practice April 2018 WPS8398.

[3] The impact of interest rate ceilings on households' credit access: Evidence from a 2013 Chilean legislation Carlos Madeira
Interest rate caps and their impact on financial inclusion Howard Miller Nathan Associates February 2013
Price Controls & The Damage They Cause, Christopher Coyne • Rachel Coyne, The Institute of Economic Affairs
IMF Working Paper Do Interest Rate Controls Wok? Evidence from Kenya C. Emre Alper, Benedict Clements, Niko Hobdari, and Rafel Moyà Porcel
Plus papers by Shaw (1973),Mackinnon (1973) Goldsmith (1969) and Levine (1997)

[4] Interest rate caps and their impact on financial inclusion Howard Miller Nathan Associates February 2013 Chapter 3

II. Inclusive lending

Financial inclusion means that wide group of individuals and businesses have access to useful and affordable financial products and services that meet their needs–transactions, payments, savings, credit and insurance–delivered in a responsible and sustainable way. It includes "regulations that make it easier for the marginalized to access financial products and services", says Governor Benjamin Diokno in his speech given before Oxford Business Group on January 28, 2020.

There is a wide variety of evidence on the relationship between financial exclusion and the availability of various forms of consumer credit. For the many low-income households who lack a savings buffer, credit of various kinds was an essential way of managing the family finances in a world where both income and expenditure needs can spike at unrelated times.

Interest rates play a strategic role in the movement and development of an economy. Interest rates can be considered as prices, and as in any price, they serve a rationing function. They are prices that allocate available funds, and command over resources, among competing uses and users. Price controls have a long history and were used particularly widely in post-war Britain and the United States. They have long been studied by economists and, typically, are regarded by economists as one of the worst forms of intervention in markets.[5] As Milton Friedman famously said: "Economists may not know much. But we know one thing very well: how to produce shortages and surpluses. Do you want a shortage? Have the government legislate a maximum price that is below the price that would otherwise prevail. If you want to create a shortage of tomatoes, for example, just pass a law that retailers can't sell tomatoes for more than two cents per pound. Instantly you'll have a tomato shortage." The government's recent imposition of a price ceiling on pork, which has led to pork shortages in the market, lends credence and accuracy of this statement.[6]

As shown by a plethora of studies, interest rate caps can force lenders to stop expanding or even withdraw services to remote rural areas and focus instead on urban areas that are less expensive to service (Miller, 2013) thus reducing Financial Inclusion. Cut off from the formal financial system, small borrowers may be forced to turn to informal lenders, which are not regulated and charge substantially higher rates. In the recently launched book, No One Left Behind: The Philippine Financial Inclusion Journey produced by the BSP, it cited its actual experience with the failed Directed Credit Program. A credit vacuum occurred and as a result, "farmers and other excluded groups had no choice but to run once again to the informal money lenders who were the only game in town".[7] Interest rate caps can thus run counter to their stated objectives of increasing affordable access to credit, especially for poor and underprivileged customers.[8] This becomes a fertile ground for illegal and predatory lenders to exist and thrive. Predatory lending is a lending practice that induces any abusive charges and loan terms on borrowers. This forces the borrower to accept unfair terms through deceptive, illegal, and coercive actions that the borrower does not need or cannot afford.

On the other hand, market-based interest rates and market-driven products have enabled financing and lending companies to innovate and develop products for a wider market targeting demographics that are not usually offered services or products by banks. A market-driven interest rate invites inclusive and transparent lending

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[5] Price Control & The Damage They Cause, Christopher Coyne and Rachel Coyne, Institute of Economic Affairs, 2015.

[6] See https://newsinfo.inquirer.net/1394150/experts-see-long-term-harm-of-pork-price-caps

[7] No One Left Behind: The Philippine Financial Inclusion Journey, Chelo Banal-Formoso and Linda Bolido, page 41

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practices, which provides reasonable access to acceptable global standards, agreed rates, and responsible lending practices.

A market-based interest rate reflects a variety of factors, but an important factor is the cost of risk and lower income customers represent a greater risk so pay a higher rate. Low income borrowers represent a higher risk because their household finances are often precarious and easily susceptible to disruption by a fall in income or an increase in demands on expenditure that, in the absence of savings or other resources to draw on can lead households to defaulting on payments.

By having the flexibility to design the terms and conditions of their products based on acceptable market standards financing and lending companies are able to serve millions of the country's poor and small and medium enterprises and providing them with opportunities to improve the quality of their lives and still manage the risk. "Regulation follows the market . . . Otherwise, the market might die because of our control", says the late BSP Governor Nestor Espenilla, Jr.[9]

III. Concerns on a one-size-fits-all interest cap

The market is replete with various products and services, which have different cost structures and targeting a wide array of consumers or demographics. These products are so diverse that some are offered to specific target customer or consumer (i.e., retired teachers or soldiers, pensioners). Some are also designed with collaterals and securities such as pawnshops. As such, an imposition of a one-size-fits-all interest rate cap would not be feasible and practicable given the diversity of products and services offered in the market.

For example, a longer-term revolving line of credit can typically carry lower interest rates than certain short-duration term loan products. A short-duration term loan, on the other hand, may carry at the onset a higher simple interest rate, but the total interest cost paid by the borrower might be substantially lower than the revolving credit scenario. A loan with collateral or security might have a lower interest rate compared to a loan without collateral or security.

It becomes necessary, therefore, to review each product or service based on the underlying parameters and the risks involved.

For fintech players the interest rate is a function of and takes into account: (i) assumption of higher risks due to the smaller buffer between income and outgo for this type of customer and information asymmetry; (ii) inability to take advantage of economies of scale because of the relatively smaller capital utilized and corresponding size of loans extended; (iii) the relatively higher cost of funds used for their lending activities (in relation to banks and other traditional credit-granting players); and (iv) relatively higher investment in technologies (vis-a-vis revenues and profits), resulting in higher overhead costs.

For financing and lending companies, it is important to gain an understanding of the composition of interest rates. The interest rate charged on loans, in simplified terms, is the sum of five components: cost of funds, overhead costs (e.g. administrative costs of the bank/financing company as well as costs of processing the loan), risk premium, profits, and taxes. As discussed in the World Bank study, if interest rate caps are set so low

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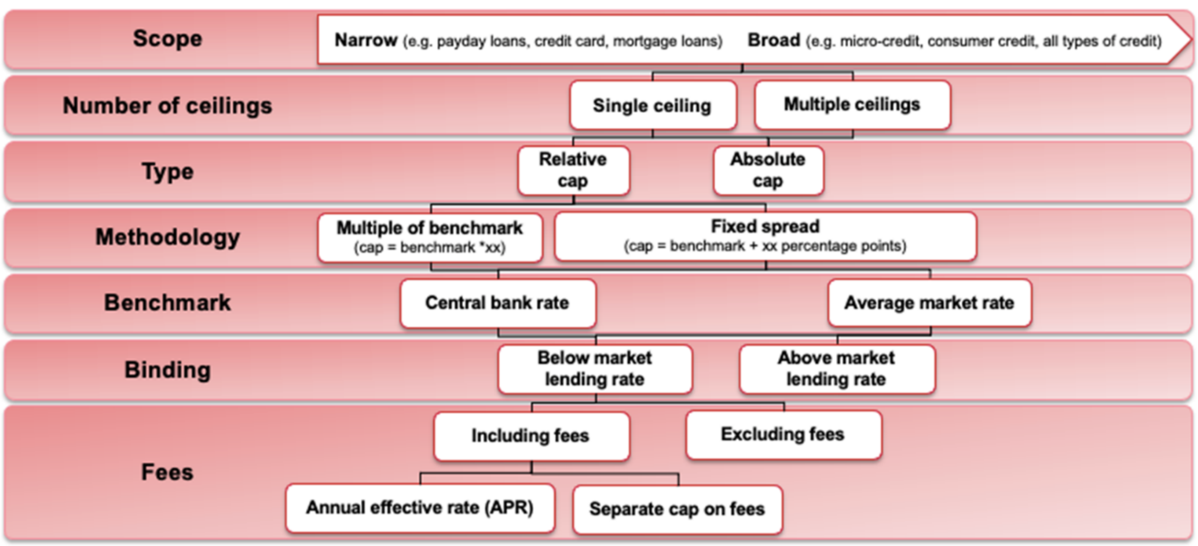
[9] [9] No One Left Behind: The Philippine Financial Inclusion Journey, Chelo Banal-Formoso and Linda Bolido, page 37

that lenders cannot recoup at least their cost of funding and overhead costs and make a non-zero risk adjusted return, it will not be economically viable for them to lend. Another response of lenders to low interest rate caps is to reduce credit extension. Studies (Staten, 2008) show that credit supply is highly elastic to price changes, and consequently a ceiling resulting in lower lending rates can trigger a swift reduction in the quantity of loans available.[10]

If the effective interest rate cap exists in a credit market, lenders will supply some, but not all, of the loan funds demanded at the interest rate cap. Thus, when lenders cannot use price to allocate loans, they must use some other criteria to allocate loanable funds. The result is almost surely that the credit demand of higher-risk borrowers will go unfulfilled.

Just as the market contains many product types, so too interest rate caps come in many different forms. Restrictions used across countries vary substantially regarding what they cover and how they work. Interest rate caps can be based on their scope, number of ceilings, type, methodology, benchmark, whether they are binding and whether they also include fees, as highlighted below.



From *World Bank*

In considering the interest rate cap the policy objective should be clear. There is a global consensus that interest rate caps are an ineffective tool for lowering the overall cost of credit and have many unintended side effects. Blanket caps further affect the distribution of credit as they result in a particularly large decline of unsecured and small loans, as well as in credit to SMEs and riskier sectors. Average loan size increases, suggesting a reallocation from small to large borrowers, in many cases to the government.[11]

Effective measures to reduce the overall cost of credit and to increase access include measures to foster competition, allow better assessment of risk and reduce fraud, including comprehensive credit bureau infrastructure, national ID schemes and efficient capital and financial markets to reduce the cost of funding for non-bank financial institutions.

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If the policy objective is to prevent usury, to protect vulnerable clients from predatory lending practices then there is evidence that caps set at a level well above market rate can be effective at removing extreme pricing with little impact on the efficient working of the market.

A primary form of variation of interest rate restrictions is the type of credit instrument and/or institution/and or borrower they apply to. The scope ranges from restrictions affecting only a narrowly defined segment of the market to broad-based regulations that affect rates on all types of credit operations in the economy.

IV. Intervention should possibly be restricted to short-term, high cost loans "Payday lending"

The Alliance believes that intervention in market-based pricing should be restricted to areas of market failure.

As previously indicated, our members welcome the recent declaration that an industry-wide study is needed to determine the interest rates charged by non-bank financial institutions, such as mobile lending platforms, on borrowings, and any rate cap must be backed by "good" and "robust" data to make sure that it is justified. In the same manner that the ceiling on interest and finance charges for credit card receivables was imposed only after the BSP's examination of various inputs, including a study on the presence of risk-based pricing, the characteristics of different credit products, an analysis of the behavior of bank lending rates, a review of practices in other jurisdictions, and consultations with the industry, we trust that extensive diligence will likewise be undertaken in connection with the proposal to impose interest rate ceilings on consumer and payday loans.

However, prior to the evidence being collected, there is anecdotal evidence that the Philippines, in common with many other countries, may have issues with short term high cost loans, often termed "Payday Loans". A quick survey of the internet showed payday lenders in the Philippines providing interest rates from 550% to 624% per annum.

One of the most rapidly growing and controversial forms of consumer lending to recently emerge in the marketplace has been payday loans or advances. While there is no set definition of a payday loan, it is usually a short-term, high cost loan, that is typically due on the borrower's next payday. The loans are for small amounts. Claims of predatory lending often arise due to the high annual percentage rates that result from the interest and fees for borrowing small amounts of money for two (2) weeks or less.

A short-term, high cost loan is usually defined as a borrower-lender agreement with an annual percentage rate equal to or exceeding 100%. This is usually done in relation to which a financial promotion indicates (by express words or otherwise) that the credit is to be provided for any period up to a maximum of 12 months or otherwise indicates (by express words or otherwise) that the credit is to be provided for a short term and not secured by a mortgage, charge or pledge.[12]

There are also behavioral aspects to pay day loans. The UK House of Lords reported "Rather than being an issue of latent demand, with an untapped customer base waiting to find a solution to its credit needs, it was suggested that television advertising was being used to market a quick, easy and tempting technological offer. Martin Lewis highlighted the "nightmare scenario" of "people watching a payday loan advert at 11pm while they are drunk and then a gambling advert" immediately afterwards, and said there was evidence that this had an impact on behaviours. This concern was shared by the Money Advice Trust, who noted that "when young

[12] www.handbook.fca.org.uk/handbook/glossary/g3184.html

people reach 16 to 24 and are thinking about borrowing, they are more likely to go for high-cost credit than the mainstream alternatives", purely because the marketing was so "slick" and the online experience so easy."[13]

Payday customers are more likely to be younger families, employed, and credit constrained. Lawrence and Elliehausen report that these consumers are more likely than the population at large to have more debt and to have filed for bankruptcy. In addition, they report that payday borrowers are more likely to have poor credit and more likely to have been denied credit. [14]

The policy objective for setting caps on payday loans is usually to prevent interest rates well in excess of the market rate and to protect vulnerable and financially less literate segments of the society from predatory lending.

In the United States, more than thirty (30) states have such ceilings on payday-loan rates. Similarly, in the United Kingdom interest and fees charged on payday loans are capped at 0.8% per day of the amount borrowed and "…borrowers must never pay more in fees and interest than 100% of what they borrowed." Canada's Criminal Code limits the interest rate on payday loans and payday loan rates are also regulated in Australia.

To quote the UK FCA: "First, fixing or capping prices can have very serious unintended consequences, including undermining the very intent of the policy and fueling black market or other criminal activity. Secondly, once a policy is in place, even if it proves to be bad policy, it can become entrenched – the direct beneficiaries are deeply vested, while those who lose out are harmed indirectly and invisibly."

"We see no reason to intervene directly in most of the thousands of prices that are set every day in financial services markets. We are concerned when these markets are not working well, for some or all customers, we will generally first look to other policy options to improve the way that competition works. But clearly there are times when we intervene directly to protect customers, including by controlling prices."

One such area is payday loans with a cap on high-cost short-term credit introduced in 2014.

The rationale for this was that in respect of high-cost short-term credit competition on price was weak– borrowers were not shopping around or comparing prices, partly because this was difficult, but also because they wanted credit urgently. Borrowers who needed cash immediately were less concerned with what credit cost and were lent money without much discipline around whether they could afford to borrow. Many then faced excessive fees and charges when they couldn't repay, suffered egregious collection practices, and found themselves trapped in debt spirals.

Narrowly defined interest rate caps are common in many countries and are focused on restrictions on the rate of payday loans. The Philippines should consider the policy objective and restrict the cap to those areas of market failure, which may include payday lending.

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[13] https://publications.parliament.uk/pa/ld201617/ldselect/ldfinexcl/132/13211.htm
[14] Edward C. Lawrence and Gregory Elliehausen, *A Comparative Analysis of Payday Loan Customers*, April 2008.

V. Government Initiatives

There are actions that can be taken to drive down the overall cost of borrowing and to outlaw bad practice, the government is proactively doing this. There are other measures in terms of competition, credit bureau and ID infrastructure, and financial literacy that could be considered.

In line with the World Bank's conclusion, a government's proactive involvement and support become necessary tools in protecting vulnerable clients particularly from predatory lending practices. In August and September 2019, the SEC issued Memorandum Circulars No. 18 and 19 to prohibit unfair debt collection practices of financing and lending companies and to fully disclose the advertisements of financing and lending companies on their online lending platforms. These Memorandum Circulars also provide penalty clauses in case of violations, which include suspension or revocation of the financing and lending companies' primary registration and/or disqualification of its directors and officers.

In July 2019, the SEC has revoked the registration of eight hundred thirty six (836) lending companies as part of its crackdown on moneylenders charging extremely high interest rates on loans in violation of Republic Act No. 9474 or the Lending Company Regulation Act of 2007.[15] The SEC also pursued those engaged in illegal lending business by issuing show cause letters to about 3,000 companies with the warning that their primary registration with the SEC will be revoked if they fail to obtain a Certificate of Authority.

The SEC's initiatives of establishing a registry for online lending platforms, requiring certain disclosures in such platforms and in advertisements,[16] and adopting the updated rules implementing the Truth in Lending Act[17] are concrete examples of regulatory efforts in a positive direction. In fact, the success of SEC's campaign clearly demonstrates the efficacy of the current regulations and the SEC's effective implementation of the laws and regulations in prosecuting illegal and predatory lenders.

To augment this campaign, the SEC can post a list of credible and compliant financing and lending companies for the public's benefit and awareness. By doing so, the public will be more cognizant of the legitimate lending and financing companies, and to only transact business with these companies verified by the SEC.

The SEC may also prescribe higher minimum capitalization requirements for financing and lending companies pursuant to Section 6 of RA No. 10881 and Section 5 of RA No. 9474 even without the need of a legislative act. Currently, the minimum paid-up capital of financing companies are as follows: PhP10M for financing companies in Metro Manila; PhP5M in other classes of cities and PhP2.5M in municipalities. For lending companies, the minimum paid up capital is only PhP1M. These amounts were established under laws, which took effect in 1998 and 2007. Due to inflation and given the length of time since the laws' effectivity, these amounts might already be considered as small. The SEC can thus increase the paid-up capitalization requirements for financing companies to PhP50M for those in Metro Manila; PhP40M in other classes of cities and PhP30M in municipalities and PhP20M for lending companies.

By increasing the capitalization requirements, the SEC will weed out fly-by-night and illegal financing and lending companies. Moreover, only those serious, credible, and financially sound financing and lending

[15] http://manilastandard.net/business/corporate/300441/sec-revokes-licenses-of-836-lending-firms.html
[16] SEC Memorandum Circular No. 19, s. 2019.
[17] SEC Memorandum Circular No. 7, s. 2011.

companies can operate. Because they are financially sound, they will not resort to predatory lending (resorting to short cuts to make profits in short period of time) and will not take the risk of having their license suspended or revoked because they have invested a considerable amount of money.

The presence of a National ID system that can easily verify an individual through a unified identification system will significantly reduce the cost and risk associated with identity verification and underwriting risks of financing and lending companies. A robust and empowered Credit Information Corporation that will provide reliable access to standardized information on credit history and financial conditions of the potential borrower will also drastically assist financing and lending companies in screening and monitoring individuals as well as avoid granting loans to high risk individuals.

There are also bills drafted by legislators, which are designed to make financing companies and financial service providers continuously evaluate their financial products and services to appropriately target the needs, understanding, and capacity of both their markets and clients. For instance, one bill requires Financial Service Providers to have written procedures for determining whether a particular Financial Consumer product or service is suitable and affordable for a client. This shall include determination of whether the amount and terms of the offered financial product or service allow a client, in terms of the individual ability, to meet the obligations with a low profitability of a serious hardship and reasonable prospect that the Financial Product or Service will provide value to its client.[18]

VI. Conclusion

We fully support the Philippine Government's move to protect the public from predatory lending.

Adequate financial consumer protection has become an important pillar for the stability of the financial sector. It also helps protect high-risk groups from abuses like predatory lending and unscrupulous business practices, without the need of imposing a ceiling on interest rates (Helms and Reille 2004). Such protection also improves the governance of financial institutions and helps them consider all the risks that arise when dealing with retail customers.[19]

Putting an interest cap on consumer loans will only prevent credit from flowing to higher risk individuals and MSMEs in contravention of the government's mandate for financial inclusion. Funds existing or made available in the market will be channeled into well-established, low-risk businesses and demographics. As a result, innovation is discouraged, economic progress is slowed, and competition is reduced tremendously.

By focusing policies and interventions on certain segments that offer loans products with exorbitant interests for shorter periods such as payday loans, this shift in government intervention will ensure that the lending public will deviate from availing products that are more expensive and may eventually lead them to be trapped in repeated revolving debts. The policy objective for setting caps on payday loans would prevent interest rates in excess of the market rate, which in turn, will protect vulnerable and financially less literate segments of the society from predatory lending. In fact, as shown by a quick perusal of interest rates from payday lenders in the

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[18] Section 8 (B), Senate Bill No. 1739 (An Act Establishing a Framework for the Protection of Financial Consumers, and for Other Purposes).

[19] Maimbo and Gallegos, Finance and Markets Global Practice Group, World Bank Group, 2014.

Philippines, payday lenders are offering annual interest rate of 550% to 624% to the obvious detriment and disadvantage of Filipino customers.

This shift in intervention coupled with financial education and counseling of borrowers will be a more efficient method in ensuring the public from oppressive and predatory lending practices.

Aside from continuous financial literacy, the development of a strong credit bureau, proper disclosure of interest rates, and endorsement of microcredit products will ensure that more Filipinos will have access to loans and funding requirements and enable them to improve the quality of their lives.

Both the regulators and the industry have valid interests in ensuring, as a policy, the continuing availability of a broad range of responsible and transparent credit products. The maintenance of a free credit market, where Filipino consumers and MSME owners have available choices among a plethora of credit and lending products that will most suitably address their requirements at the most viable price, will be equally beneficial to all parties and stakeholders involved.

Respectfully submitted.

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