The AMERICAN CHAMBER of Commerce in Mongolia

POSITION PAPER ON DRAFT LAW ON INTEREST RATE CAPS

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Position Paper on
Draft Law on Interest Rate Caps

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BACKGROUND

In April 2019 Amcham's Financial Services Committee ('AFSC') was presented with the draft Law on Setting Maximum Legal Rate of Loan Interest and Combatting Usury ('Draft Law') - (translated into English from the original Mongolian version). Based on the information disclosed we are now formulating our position about the draft regulation ('Policy Document').

VERSION & KEY PROPOSALS

We are unsure whether the version we saw is the latest, hence we provide a brief summary of the maximum rates proposed in the Draft Law:

4.1. The **maximum legal interest rate** for following types of loans from bank and legal entity authorized to carry out loan activity shall be set as follows:

4.1.1. The maximum legal interest rate for loan up to 100 million MNT for supporting Small and medium enterprises – 18 percent per annum;

4.1.2. The maximum legal interest rate for Salary loan - 18 percent per annum;

4.1.3. The maximum legal interest rate for Pension loan - 12 percent per annum;

4.1.4. The maximum legal interest rate for all other types of loan - 24 percent per annum.

The draft also includes a list of proposed prohibited activities:

6.1. The following activities are prohibited for loan activity:

6.1.1. Usury;

6.1.2. To charge the interest rate in advance;

6.1.3. To charge loan disbursement fee, loan extension fee, cash withdrawal fee and other types of fee.

Assumptions and Understanding of the Draft Law:

For the purpose of our Policy Document we are making a number of assumptions about the purpose and intention of the Draft Law. To make sure our understanding is aligned with this of the authors of the Draft Law, we list these assumptions here:

- The primary intention is to protect consumers from excessive and usury interest rates (if correct, we agree with this objective; this objective however should be embedded in financial sector consumer protection law and regulations).
- The primary origin of usury interest rates appears to be the rise of NBFI app based and pawnshop short term lending. The term "usury" should focus on the concept of loan-sharking and predatory lending, and, again, embedded in consumer protection law.
- The secondary intention may be to create cheaper credit for private individuals and companies and make it more accessible (we do not believe that the proposed interest rate caps will achieve this objective because reducing the funding costs or increasing the availability of low-cost funds are not part of the proposed law).
- Another intention may be to indirectly increase the savings ratio in the country by limiting access to credit and discourage consumer spending based on credit (if correct, we do not believe that worsening of access to credits, deposit flight out of the system, deterioration of liquidity conditions, and credit crunch increase the savings ratio).
- We assume that legislators believe that lower interest rates will be beneficial for the whole Mongolian economy (we agree with this concept, but the overall lowering of interest rates needs to be achieved through different means, mainly by reducing sovereign risks, and strengthening macro-financial conditions).

High Interest Rate Environment:

High interest rates increase the financial burden of all borrowers, private individuals, SME's, corporates and the Sovereign. If the cost of borrowing money is high, all sectors of an economy see insufficient investment. Families find it harder to purchase property, and Governments have difficulty sustaining infrastructure spending

Interest rates however are high for a complex set of reasons. These include country risks, sovereign rating, economic structure, macro-financial stability, international credibility, reliability of a judicial system, legal and regulatory environment, high inflation, cost of funding, efficiency of financial intermediation, lack of savings and funding, monetary policy, maturity and health of a banking system, and many more. Interest rates are the result of supply and demand, and the introduction of an interest rate cap, or an artificially low interest rate distorts this balance and worsens access to finance. Theoretically, the supply of credit in a country significantly reduces and ultimately interest rate rises. Interest rates are a reflection of perceived risk, and if interest rates are capped, there will also be groups of borrowers which are perceived to be too risky for the banking system or indeed for NBFI's and fin-tech companies and will not therefore be able to access credit anymore.

We do not think that this can be the objective of the Draft Law.

The effects of high interest rates on inflation and other financial or economic parameters are outside the scope of our policy document.

IMF Working Paper (Kenya):

As recent as May 2019, IMF published a Working Paper 'Do Interest Rate Controls Work. Evidence from Kenya'.*

The abstract of this document details:

- *Interest rate controls in Kenya were introduced in September 2016. The intent of the controls was to reduce the cost of borrowing, expand access to credit, and increase the return on savings. However, we find that the law on interest rate controls has had the opposite effect of what was intended. Specifically, it has led to a collapse of credit to micro, small, and medium enterprises; shrinking of the loan book of the small banks; and reduced financial intermediation. We also show that interest rate caps reduced the signaling effects of monetary policy. These suggest that (i) the adverse effects could largely be avoided if the ceiling was high enough to facilitate lending to higher risk borrowers; and (ii) alternative policies could be preferable to address concerns about the high cost of credit.*

Quoting this abstract does not imply AFSC automatically endorses all IMF policies.

Asia Development Bank:

We have also reviewed Impact of Restrictions on Interest Rates in Microfinance, published by Asia Development Bank in September 2016 (general document, not related to Mongolia).**

This document includes a very useful overview of countries where interest rate restrictions are in place. Interestingly, the document introduces three different concepts, how they are defined and implemented.:

- interest rate controls: imposed via banking, finance, or central bank laws (which is what is proposed in the Draft Law)
- usury limits: are aimed at private consumer lending and usually affect NBFI's (which appears to be the targeted intention of the Draft Law).
- de facto controls: political or regulatory pressure to follow governmental interest rates (this does not appear to be applicable in Mongolia).
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Interestingly, the document states that usury limits are typically handled through Civil Law, and not through interest rate caps. As mentioned, this document does contain a useful overview of instruments available to governments and policy makers to try and control or limit interest rates, even in developed countries.

* https://bit.ly/2XKjFuI
** https://bit.ly/2Sm3HRj

World Bank

In October 2014 the World Bank published a paper on Interest Rate Caps around the world.*

This is an abstract of the document:

- *The paper concludes that there are more effective ways of reducing interest rates on loans over the long run and of improving access to finance: measures that enhance competition and product innovation, improve financial consumer protection frameworks, increase financial literacy, promote credit bureaus, enforce disclosure of interest rates, and promote microcredit products. Such measures should be implemented in an integrated manner.*

Overall Recommendation:

This Policy Document has presented its overall views on why interest rate controls are unlikely to achieve the objectives which we assume the Authors of the Draft Law had in mind. But apart from not achieving the objectives, from our professional perspective there would also be quite a range of negative unintended consequences. These can be summarized in two categories:

- Borrowers: certain groups are likely to become excluded from the credit market, because the interest rate for these potential customers cannot be set to reflect the risk profile, probability of default and loss given default. In the end, access to credits and financial intermediation for individuals, households, micro and small businesses will severely worsen and credit crunch risk will be heightened.
- Banks: if interest rate caps are set, it is quite obvious that the profitability of the banking sector as a whole, but mostly those banks with a retail, SME or microfinance strategic focus, will significantly reduce. Such reduction would take place only shortly after shareholders have injected new capital, when new capital adequacy ratios are likely to be introduced and the calculation of risk weighted assets will become more onerous. Return on equity will reduce and it will become more difficult to attract new equity and indeed new international credit. Banks will be under pressure to artificially reduce their deposit interest rates, which then translates to deposit flights, deterioration of liquidity, credit crunch, shrinkage of the balance sheet, and financial sector instability.
- NBFI's and Fin-Tech companies: if the consumer protection is set in the wrong manner there is a significant possibility that NBFI's and Fin-Tech companies active in consumer lending will go out of business.
- Investment and business environment: If interest rates are capped, foreign direct investments and foreign funding will significantly be discouraged, and the overall business environment will deteriorate. The introduction of interest rate caps will be negative for the economic development and outlook of the country.
- The introduction of the Draft Law may have the unintended consequence that lenders increase their lending in foreign currency as the proposal sets limits only on MNT loans. There is also a risk of increasing lending activity between individuals, outside of the financial system leading to uncontrolled and eventually usury lending.

* https://bit.ly/2JQAsCi

Cooperation with BoM and Mongolian authorities to reduce the cost of lending:

In order to lower interest rates through reducing the cost of lending the financial services industry and Mongolian authorities should cooperate how to enhance access to credit information, improve lending infrastructure and legal system. More specifically but not exclusively we would like to consider the following topics:

- **Decrease cost of funding in the financial sector**
- **Decrease inflation and maintain it at low and stable level**
- **Enable stable environment for foreign exchange rates**
- **Decrease non-performing loans and enhance asset management mechanism in the financial system**
- **Enable the legal system for debt collection**
- **Decrease foreign currency swap costs**
- **Improvement of the credit bureau system (data and access)**
- **Increase efficiency of credit guarantee fund**
- **Enable the legal system for online lending and online financial services**
- **Decrease interest rates of subsidized MIK loans**

Closing Comment:

This Policy Document was produced with input from all members of AFSC which represents a broad specter of the financial system in Mongolia. Its sole intention of the Document is to contribute to a broader financial system in the country and to improve the international creditworthiness. AFSC remains at your disposal to discuss the above specific proposals in more detail.

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