Economic Watch

Emerging Economies

Madrid, 23 January 2012
Economic Analysis

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Interest rate caps: back to the future in LatAm?

- **Although after the liberalization of many financial systems in LATAM in the late eighties market-determined interest rates became predominant, a few countries did maintain interest-rate caps in the regulator's toolkit as an instrument to prevent excessive levels**
  This, in cases where either market conditions were deemed weak, or to prevent usury.

- **The events of 2008, which provoked high delinquency rates and a credit squeeze, reignited the debate on the adequacy of market interest rates and the need of constraining them to protect consumers in several countries**
  This also occurred in some Latin American countries where, in spite of the limited impact of the crisis, authorities and/or legislators were not fully satisfied with the overall banking credit conditions.

- **There is recent evidence of new or more restrictive provisions to cap interest rates in Ecuador, Mexico and Chile**
  But in sharp contrast with the developments in these three countries, in Colombia the most recent changes to maximum interest-rate regulations have been towards their easing.

- **The merits of interest rate caps will continue to be discussed in the coming years. The reason is that although economic theory suggests some cases in which interest rates caps can improve free-market outcomes, empirical evidence of their effectiveness remains to a large extent mixed or even negative**
  Recent evidence in Latin America suggests that the presence of interest rate caps is associated with less financial access. Moreover, in an environment where there is limited coverage by credit bureaus, inadequate protection of creditors' rights, and a low level of financial education, the public policy agenda requires a variety of different types of instruments to tackle institutional deficiencies. Interest-rate caps may therefore not be a key policy tool and the resulting price distortion may produce other inefficiencies.

Interest rate caps: back to the future in LatAm?

The liberalization of many financial systems in LATAM in the late eighties and early nineties eliminated complex credit allocation mechanisms. Quotas, high reserve requirements, excessive barriers to entry into banking activity and interest-rate caps were largely replaced by market-oriented means with the purpose of fostering efficiency and access to credit. In addition, fiscal control and monetary policy institutions were set up, leading to significant reductions in inflation and interest rates. As a result of these modifications, financial systems grew at a fast pace throughout the region. Moreover, as better macro prudential regulations and supervision came into force, this growth became sustainable. In fact, bank credit throughout LATAM not only expanded very vigorously before the 2008 financial and economic turmoil, but in its aftermath contracted less than in other regions. While market-determined interest rates became predominant in LATAM (e.g. Bolivia, Brazil, Costa Rica, Guatemala, Honduras, El Salvador, Mexico, and Panama)[1], it is worth noting that a few countries did maintain interest-rate caps in the regulator's toolkit as an instrument to prevent excessive levels, either when market conditions were deemed weak, or to prevent usury[2]. To illustrate these provisions, we will briefly describe the regimes of Chile, Colombia and Peru[3].

In Chile, since 1981 the law has set the maximum interest rate at 50% above the current or average interest rate (Tasa de Interés Corriente, TIC). Hence, the maximum or Conventional Maximun Interest Rate (Tasa de Interés Máxima Convencional, TMC) is 1.5 times the TIC. The Superintendency of Banks and Financial Institutions (Superintendencia de Bancos e Instituciones Financieras, SBIF) has determined nine categories of credit operations based on size, currency and term[4]. At present, eight of these categories have average interest rates below 17% per year. The average for the category of loans under CLP 4.3 million (USD 9,350), which accounts for 7.5 million operations (half of the system), is 33.6%, so the respective TMC is around 50%.

Colombia has since 2000 defined by law the usury interest rate as the maximum interest rate that can be charged for credit operations. This usury rate is 1.5 times the Current Banking Interest (Interés Bancario Corriente, IBC). The Financial Superintendency (Superintendencia Financiera) uses banking interest-rate data to calculate the IBC for the segments of commercial and consumption credit and for micro credit. The law authorizes financial institutions that offer microcredit to charge fees and commissions authorized by the Superior Counsel of Microenterprises (Consejo Superior de Microempresa) in addition to the interest rate. Although this framework is similar to that of Chile, several studies suggest that interest-rate caps create burdens for the segments of credit cards and micro credits and have hindered access to banking services[5].

In Peru, the law states that the Central Bank of Peru aims for interest rates to be determined through free market competition and "only in exceptional circumstances has powers to set caps and floors on interest rates with the purpose of regulating the market."[6] In practice, Peru's Central Bank has interpreted that these exceptional circumstances are when the markets are not competitive. To support this interpretation, it sends periodical reports to the Congress[7] and has so far not established any maximum interest rate.

1: A good overview about interest-rate regulations and their impact in LATAM is presented in Capera, L., Murcia, A. and D. Estrada (2011), "Efectos de los Límites a las Tasas de Interés sobre la Profundización Financiera", Reporte de Estabilidad Financiera, Banco Central de la República de Colombia.
2: Notice that as an instrument to preclude usury, the powers of interest rate caps are constrained to formal or supervised credit providers.
3: Caps on interest rates also are in place in Argentina, Paraguay, Uruguay and Venezuela, .In Argentina, interest rate caps are in place in several segments, (see methodological details in Tasas de Interés en Operaciones de Crédito, Banco Central de la República Argentina, Texto ordenado al 30/11/2010); but only those on credit cards' interest rates are considered binding by banks. In Uruguay, interest rate caps are not deemed as binding,. In Paraguay and Venezuela there are also interest rate caps for many segments (in Venezuela, there is also in place a system of credit quotas) and several are considered as restrictive. See Capera, et al (2011) for more details.
4: More details about the methodology used to determine the TMC can be found in Flores, C. Morales, L., and A. Yáñez (2005), "Interés Máximo Convencional Origen, evolución y forma de cálculo" Serie Técnica de Estudios - Nº 002, Superintendencia de Bancos e Instituciones Financieras, Noviembre de 2005.
5: See, for example, Estrada, D., Murcia, A. and K. Penagos (2008), "Los efectos de la tasa de interés de usura en Colombia", Coyuntura Económica, 2008, 38(1), pp. pp. 45-57. More recently, the association of Colombia presented the government with a proposal to remove the usury interest rate in order to expand micro credits. See for more details: "Hacia una tasa de usura que refleje mejor las tendencias del mercado" Semana Económica, Asobancaria, August 8, 2011.
6: See Article 52 of the Central Bank's Organic Law (Ley Orgánica del Banco Central) for more details.
7: See Mesia, M., Costa, E., Graham, O., Soto, R. and A. Rabanal (2006), "El Costo del Crédito en el Perú: Revisión de la Evolución Reciente", Banco Central de Perú, DT N° 2006-004, June 2006.

The events of 2008, which provoked high delinquency rates and a credit squeeze, reignited the debate on the adequacy of market interest rates and the need of constraining them to protect consumers. This unresolved debate has taken place not only in the industrial economies that were most affected, but also among some Latin American countries where, in spite of the limited impact of the crisis, authorities and/or legislators were not fully satisfied with the overall banking credit conditions, such as protection for users of financial services. There is recent evidence of new or more restrictive provisions to cap interest rates in the following countries:

Ecuador: In 2007, a few months before the international financial meltdown, and in fact mainly due to a turbulent domestic environment, the government passed a reform to the banking law that aimed at setting maximum interest rates[8]. From this time on, maximum passive and active interest rates have been determined by the Central Bank of Ecuador. Active interest rate caps are calculated as a weighted average by segment and multiplied by a credit risk factor, because Ecuador's economy is dollarized and its basic interest rate is strongly linked to the United States' monetary-policy interest rate set by the FED. They are reviewed regularly. As a result, these interest rates have diminished, but illegal lending has flourished and needs to be prevented through more supervision and control.

Mexico: In 2010 the law to promote transparent and ordered financial services was reformed to increase the Central Bank's powers to regulate the characteristics of financial services, including interest rates[9]. In particular, the law mandates the Central Bank to collect and process data from financial entities in order to regulate active and passive interest rates, commissions and payment conditions in the operations that banks and regulated financial institutions perform with their customers. Under the law, the Central Bank must issue a justification for these regulations that takes into account aspects such as the prevailing financing conditions in the market, funding costs, operation and administration costs, default probabilities, expected loss, and an adequate capitalization of financial institutions; moreover, such regulations may only be in place while the conditions that motivated them persist. Until now, the Central Bank has not used its powers to regulate interest rates. However, it did publish the Rules for Credit Cards with the aim of encouraging information transparency and user protection. These rules include a floor to minimum payments on credit cards, a ban on the issue credit cards unless they are requested by the customer, and a ban on any increase on the credit card interest rate stipulated in the contract within the first 12 months. It also published Rules for Total Annual Yield, Rules for Basic Payroll Accounts and Basic General Public Accounts, limits on fees for late payment, and information requirements on ATM charges.

Chile: In October 2011 a group of senators proposed to set the TMC as 3 times the monetary-policy interest rate. Since the monetary-policy interest rate is 5.25%, this would put the TMC at around 16% per year. In response, the government has proposed to reduce the parameter applied for TMC calculation from 1.5 to 1.35 and to set the TMC as the minimum between this value and the TIC plus 12% for loans in non-adjustable pesos of under 200 Unidades de Fomento (UF) and terms of above 90 days. For other loans the TMC would be a maximum of between 1.5 times TIC and TIC plus 2%. So the TMC for small loans would decrease from around 50% to around 40%. The Senate agreed to merge and discuss both proposals, which have received comments that bring them closer in the last weeks. There is also a proposal to define a specific auditor for non-banking credit suppliers (that is, for retail stores, cooperatives, etc.) and to raise sanctions against those who breach the TMC.

In sharp contrast with the developments in these three countries, there is one country where the most recent changes to maximum interest-rate regulations have been towards their easing:

8: For more details, see the Money Regime and State Bank Law (Ley de Régimen Monetario y Banco del Estado) and its subsequent modifications (Regulation 009-2010), and the Central Bank of Ecuador's Regulation Code (Codificación de Regulaciones del Banco Central de Ecuador).

9: For more details see Article 4 of the Law for Transparent and Ordered Financial Services (Ley para la Transparencia y Ordenamiento de los Servicios Financieros). To determine interest rate regulations, the law stipulates that the Central Bank can obtain the opinions of other financial and competition authorities.

Colombia: At the end of 2010 the formula limiting interest rates for consumer credit and microcredits (usury rates), which amounted to 1.5 times the IBC, became less stringent. The formula now in place calculates a simple average of the interest rates in the previous 12 weeks for different segments (consumer, commercial, credit cards, mortgages, etc). The previous binding regulation calculated the IBC as a weighted average of interest rates by segments, which skewed the rate downwards because of the large weight and relative low interest rates of the commercial segment. In the case of microcredits the calculation takes the previous 52 weeks into account. Moreover, in December 2011 the government decreed that banks and financial institutions must observe the following conditions when determining and publicizing fees and charges other than interest rates: i) a limit of COP 3,965 (20 UVR) for ATM cash withdrawals with a card issued by a different bank; ii) a prohibition on charging for failed transactions; iii) a prohibition on increasing or adding fees without notifying the customer at least 45 days in advance; and iv) a rule establishing that fees and charges for internet transactions must be cheaper than those for transactions through other channels.

The merits of interest rate caps will continue to be closely scrutinized in the coming years, because economic theory suggests some cases in which they can improve free market outcomes, but empirical evidence of their effectiveness remains largely mixed or negative[10]. However, there are two important considerations to be made when discussing how this topic affects Latin America. The first is that several studies, including a very recent one focused specifically on LatAm[11], do confirm that the presence of interest rate caps is associated with reduced financial access, especially among low-income groups. In the case of Colombia, where interest rate caps have now become less restrictive, an important body of empirical evidence on this kind of adverse effect had accumulated since the caps first came into place. Second, as LatAm financial markets are largely underdeveloped, several aspects may induce their interest rates to be high; for example, limited coverage of credit bureaus, inadequate protection of creditors' rights, lack of assets to use as collateral, a low level of financial education, etc. When these conditions prevail, the public policy agenda demands a number of instruments of different types to tackle the deficiencies in the institutional framework first, and in a direct manner. Interest rate caps may therefore not be a key policy tool and the price distortion may produce other inefficiencies.

10: See "Study on interest rate restrictions in the EU, Final Report for the EU Commission DG Internal Market and Services", Project No. ETD/2009/IM/H3/87, Brussels/Hamburg/Mannheim for a very complete and thorough review of this topic from both the legal and economic perspective.
11: Capera, et al. (2011).

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