Microcredit: A promise that fails to meet expectations

They were created to favor microentrepreneurs, but it turns out that when the Central Bank of Colombia lowers the interest rate, it is the only product in which this correction is not reflected. The effect is completely different than expected.

By Claudia Jasmín Flechas
Photos Milagro Castro, Juan Ramírez, Ximena Serrano
DOI https://doi.org/10.12804/dvcn_10336.37300_num6

"I got a microcredit to buy a coffee maker, but then I did the math and I ended up paying like 5 times more. It was not a good decision," says Aurora Martínez, a user of this financial product.

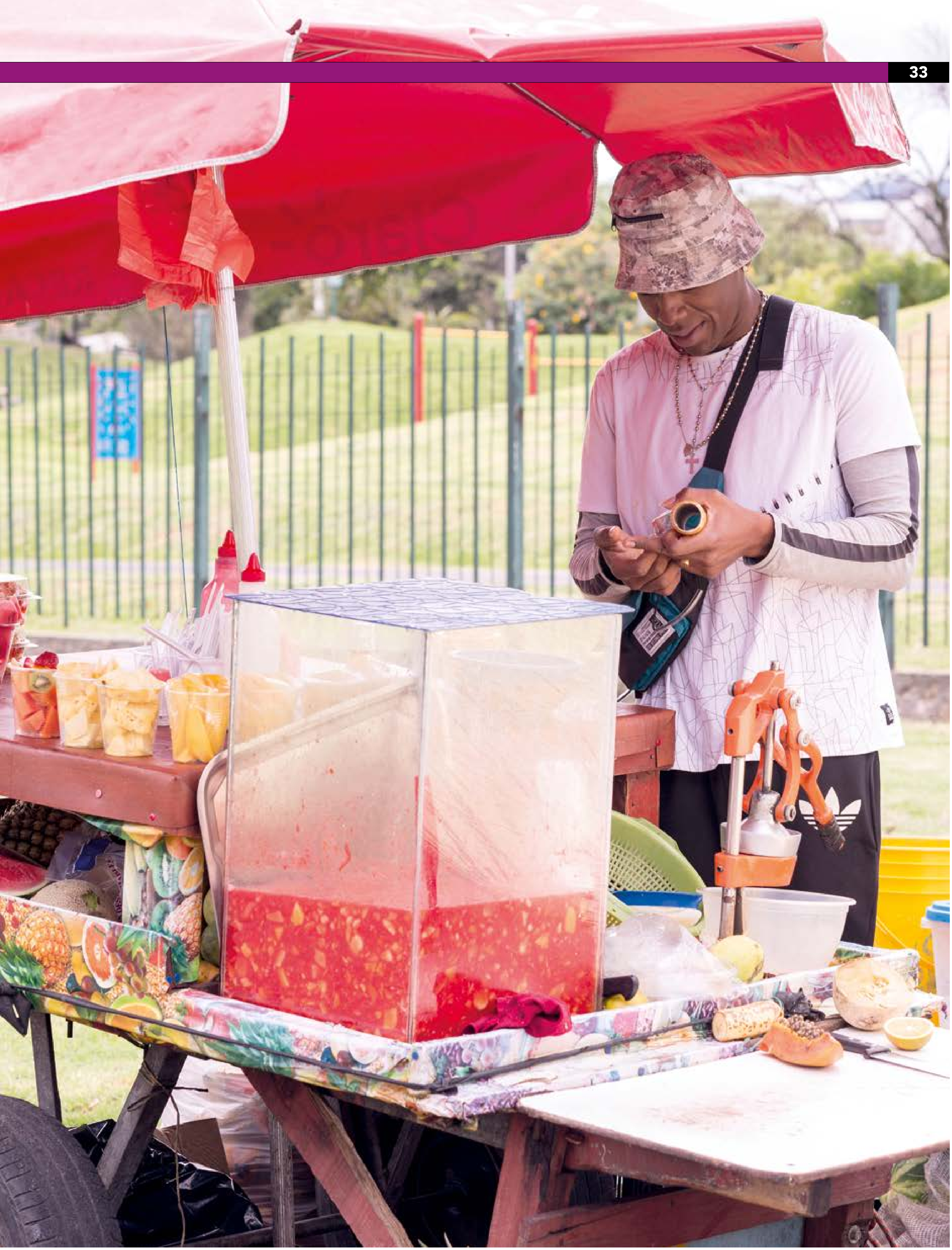
What about the interest rates on microcredits? Do they actually achieve the goal of strengthening entrepreneurship, improving income levels, and, especially, being a financial solution for microentrepreneurs?

At Universidad del Rosario, the Formal and Inclusive Economy Alliance (EFI Alliance), made up of 18 stakeholders (including international partners, higher education institutions, and productive sector entities) and financed by the government initiative Colombia Científica, studies the phenomenon of informality from different perspectives. A specific line of *Project 7, Social Laboratory: Tools for the Management and Appropriation of Knowledge for the Design of Public Policies and Dissemination of Scientific Knowledge* specializes in access to credit. There, a group of researchers conducted an exercise that yielded interesting findings.

"One of the functions of the Banco Central de la República (Central Bank of Colombia) is to manage the country's monetary (inflation control) and financial policy," says Aglaya Batz Liñeiro, a professor at the School of Management of Universidad del Rosario, a member of the group of authors involved in the research study and a researcher for the EFI Alliance program. "When modifying its rates, it establishes minimum values so that the so-called usury rate is not exceeded. So, when the Central Bank lowers rates, one would automatically expect all financial product rates to go down. The question is as follows: How long does it take for banks to correct the rates of their financial products, or rather, how long does it take for the market to react to changes in bank rates? Most financial products end up correcting themselves after 3, 6, or 12 months, but this is not the case for microcredits," she points out.

This is information that should be available to those seeking access to microcredit, but which most people ignore and which would certainly influence their decision making.

→ For the people who, for example, sell juices or arepas at a small scale, revolving funds or other products should be created to foster the scaling up of their activity.



Result of a thorough observation exercise

The research work entitled Analysis of the transmission of the monetary policy interest rate on the microcredit interest rate in Colombia: Discussions of independence (2021) examined people's access to credit, especially of informal workers, based on the reasons for applying for such credits:

- Based on knowledge and seeking the greatest personal benefit; although sometimes the decisions made are detrimental to their interests due to ignorance on how the financial sector works.
- Based on the geographic location of the banking entities, cooperatives or institutions authorized to give credit.
- Based on the ease of the formalities required to access these credits.

"When we began to investigate the academic support to validate these three hypotheses, we asked ourselves about the impact of the moderation effect exerted by the Central Bank on these financial products, especially microcredits," continues Batz Liñeiro. "We realized that when the Central Bank lowers interest rates because it needs more people to access credit, the banks that grant microcredits keep them high. The effect is completely different than expected, and it is the only product that behaves this way."

To reach this conclusion, the researchers analyzed the records for the past 10 years of the Superintendencia Financiera de Colombia (Financial Superintendence of Colombia), the entity that controls and manages the official information, both of the rates set, and the disbursements made by the financial institutions. Furthermore, they reviewed the rates set by the Central Bank of Colombia in the same period of time.

With this information, they correlated and analyzed the data and found the behavior of the rates for microcredits.

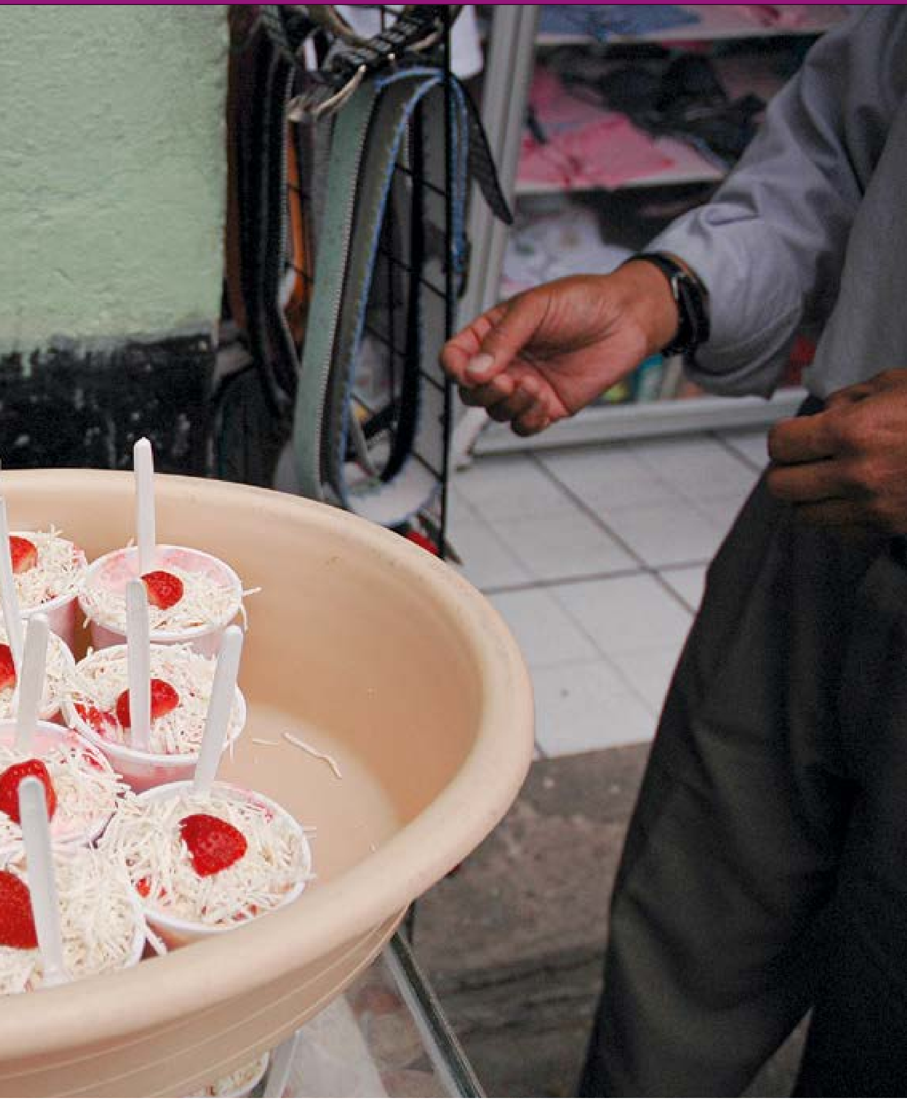
Why are microcredit interest rates soaring?

The theories considered in the study focus on these three reasons:

1. The Central Bank lowers the rate because demand is much higher. A perfect example is what happened as a consequence of the COVID-19 pandemic: the bank lowered the rate considering that many more people would need access to loans. But as the demand for financial services grew, especially microcredits, the banks and cooperatives decided not to lower the rate because demand rocketed.
   José Orlando Montes de la Barrera, co-author of the study and an EFI Alliance researcher, stated that they found that the higher demand for microcredits is consistent with higher interest rates.

2. The people who access this type of products are those with a higher risk as marked by the financial system or who are much more likely to fail to make the required payments to settle the debt. Therefore, given a greater risk of this happening, microcredits do not lower the rate. Most people ignore that consumer loans are much more likely to have a lower interest rate than microcredits.
   Disbursements are higher at those microcredit establishments with higher interest rates, which does not make much sense, according to Montes de la Barrera.

→ The purpose is to help microentrepreneurs to improve their working conditions and wellbeing so that they grow from survival ventures to transformational undertakings.



3. The major opponents of microcredit compete under the illegal modality known as "drop by drop" and through informal financing (loans from friends, neighbors, and others).
   In practice, therefore, microcredits operate at rates that may even be close to usury (see box below).

Another approach and importance of microfinance institutions

For [Andrés García,] professor of Economics at Universidad del Rosario and researcher of another line of the EFI Alliance, access to these financial instruments is very important for microentrepreneurs, "firstly, because it facilitates growth and investments in any business; secondly, because it is a mechanism to mitigate impacts or shocks that may affect them, as it occurred during the pandemic."

In his opinion, it is necessary to have a more specific offer of financial products for microcredit. "Microfinance companies have made great progress in this respect, and it is already a fully consolidated segment that also offers support

Some basic concepts

A microcredit is a financial instrument designed and regulated for microentrepreneurs and self-employed individuals. In Colombia, there are essentially two microcredit types: personal and for businesses.

In both cases, the microcredit must not exceed 120 minimum legal salaries in force (SMLV, by its acronym in Spanish).
Those who define or design financial products are banks, cooperatives, and entities authorized and regulated by the Colombian financial system.

"Drop by drop" are informal loans offered by individuals to cover an urgent consumption need. They are not supervised by a State supervisory entity, so they operate illegally with very high interest rates and constitute a socioeconomic problem that grows in the midst of informality and low banking penetration.

The problem of interest rates on microloans: COVID-19 case, a clear example

When the Central Bank of the Republic intervenes, it does so to regulate consumption. During the pandemic, this institution lowered the interest rate three or four times.
At that time, people were unemployed and needed credit. The Central Bank of the Republic usually lends to financial institutions at a certain rate, for example, 2%; thus, they set their rates at 2.3%. Later on, the Central Bank of the Republic decided to leave it at 3% because it did not want there to be so much consumption, either because there was enough demand or because the market stabilized again. According to our example, at that time, banks started to lend at 3.2% or 3.5%.

These corrections are not made automatically because there is already money circulating at a different rate. Banks, then, begin to correct their products progressively, after three or six months or even a year.
But the only product in which this does not happen is microcredit. When the interest rate falls, the opposite happens, i.e., the microcredit rate rises because there is greater demand, and that is when it begins to compete with the "drop by drop."

during the loan term, which is highly beneficial for the user. However, although there are good products, there is still room for improvement in this area," he says.

Regarding the phenomenon observed in this article and the interest rates, Professor García assures—bearing in mind that the credit market is characterized by its lack of homogeneity and by considering the level of risk as a priority—that banks always look for the best clients, those who have better payment capacity. In the case of microcredits, it is normal to find people with no credit history, which is very valuable information for the bank to evaluate the default risk of each client. Thus, many people cannot access these debt and investment mechanisms, or if they do, the bank's ignorance about their payment capacity translates into high interest rates.

"This means that on many occasions, even if rates go down and the market introduces flexibility to the cost of credit, this inability to profile clients very well means that this is not reflected in the interest rates of microcredits," García explains. "Thus, this implies the importance of microfinance companies, which focus on specific credit profiles to provide them with an adequate interest rate."

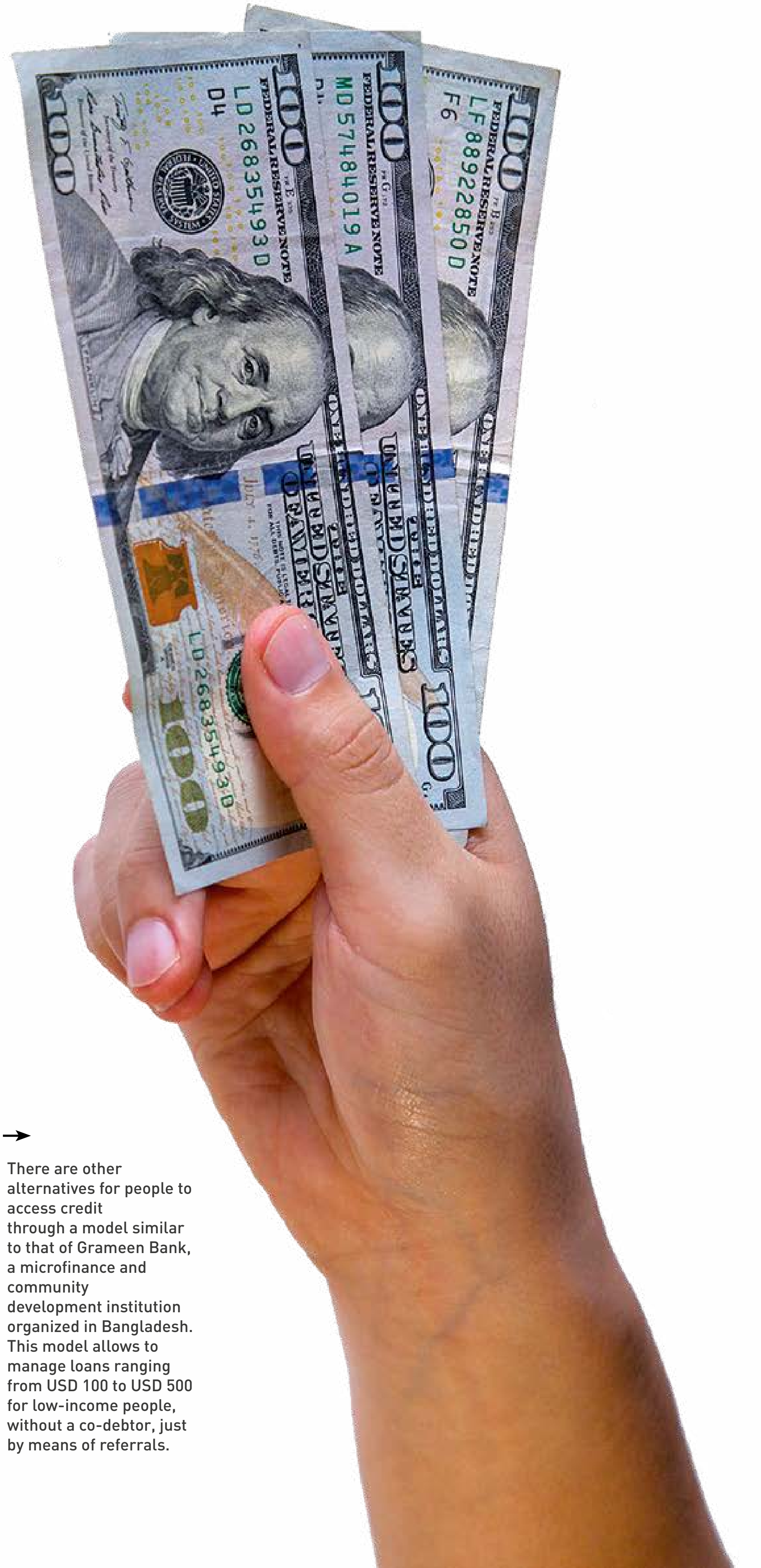
All this contradicts the main purpose of microcredit, which is to support the most disadvantaged microentrepreneurial population, and in the end, those who end up receiving the credit are those with the best conditions and who usually do not need it most.

Dissociation between banking and the real world?

"We are a highly unequal country characterized by a part of the population that concentrates a lot of money and works for the financial system, another great part that is neglected," says Montes de la Barrera. "So, ideally, we should gain an understanding of reality and create products and services that respond to the actual needs of a country like Colombia in its entirety."

To understand these consumers who are neglected by banks and by the State itself, the researchers warn that it is urgent to propose different products for them:

- **Migrants:** A latent problem in Colombia; it is extremely difficult for this group to access microcredit. There are no financial products to help them start their businesses. In



There are other alternatives for people to access credit through a model similar to that of Grameen Bank, a microfinance and community development institution organized in Bangladesh. This model allows to manage loans ranging from USD 100 to USD 500 for low-income people, without a co-debtor, just by means of referrals.

the meantime, migrants are absorbed by the "drop by drop" or by applications that are not a real solution.

- **Survival Entrepreneurs.** For people who, for example, sell juice or *arepas*, but on a small scale, revolving funds or other products should be created to support the scaling up of their activity.

- **Financial Education.** Educating microcredit consumers is a pending task since they do not always make the best decisions but are acquiring credit at quite high rates without being aware of it. Therefore, it is necessary to put in place education mechanisms that include easily accessible platforms wherein they can make comparisons, see in real time which institutions offer them a more favorable rate, where they have fewer requirements, and payment terms, among others.

The Near Future

Within the social laboratory of the EFI Alliance, the challenge was to build a social laboratory to observe the phenomenon of informality. The idea is to continue this goal once the Alliance ends (September 2023) so that the joint efforts made by Universidad del Rosario and the other partner institutions are aimed at continuing to observe this phenomenon.

The purpose is to help microentrepreneurs improve their working conditions and wellbeing so that they can evolve from survival enterprises to transformational enterprises, i.e., they can follow the business curves and achieve significant economic growth.

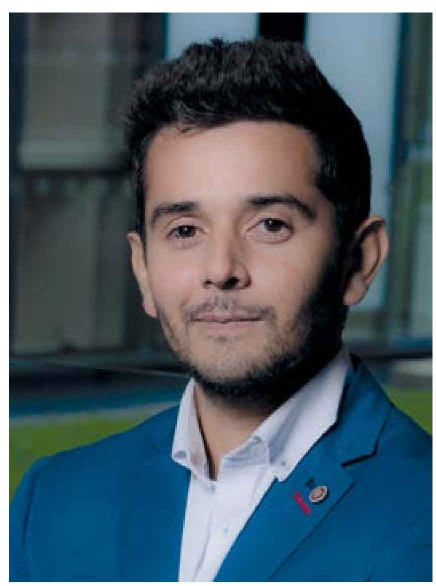
Some external elements have developed significantly in recent years, such as mobile applications for making transactions (Nequi, TransfiYa, and Daviplata), which have enabled many informal workers to access a bank account or transfer money. This is a major milestone that will definitely allow for new and different actions.

Furthermore, some companies are investigating blockchain and cryptocurrency technologies for the design, execution, and monitoring of credits and to boost the traceability and transparency of their processes.

Finally, there are other alternatives for people to access credit through a model similar to that of the Grameen Bank, a microfinance and community development institution organized in Bangladesh. This model allows to manage loans ranging from USD 100 to USD 500 for low-income people, without a co-debtor, just by means of referrals. In Colombia, Fintech-based ventures can (and are already doing it) change or supplement the Colombian financial sector since, by reaching these unbanked populations and developing new financial products or services, they offer more alternatives to develop these populations that need a small boost to create value in our economy.

"We realized that when the Central Bank lowers the interest rate because it needs more people to access credit, the banks that grant microcredits keep them high. The effect is completely different than expected, and it is the only product that behaves this way," explains Aglaya Batz, researcher at the Management School of Universidad del Rosario.

Andrés García, professor of Economics at Universidad del Rosario and researcher of the labor market and urban economy of the EFI Alliance, assures that "banks always look for the best clients, those who have better payment capacity. In the case of microcredits, it is normal to find people with no credit history, which is very valuable information for the bank to assess the default risk of each client."



José Orlando Montes de la Barrera, co-author of the study and also a researcher at the EFI Alliance, comments as follows: "We are a highly unequal country characterized by a part of the population that concentrates a lot of money and works for the financial system, another great part that is neglected."