How to tackle information asymmetry in the microfinance market in Kenya

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I had an internship with Mtongwe Community Initiative in Kenya last November. The organisation works in Mtongwe and addresses a wide range of issues including HIV/AIDS, poverty, education, health and sanitation at a grass root level. Mtongwe is a community located in the suburb of Mombasa, the second largest city in Kenya. After some focus group interviews with locals, I came to realise that the majority of microfinance borrowers lacked sufficient knowledge and information about their loan conditions. I explore this problem of information asymmetry between microfinance institutions and borrowers here.

Lack of information about loan conditions

I had five focus group interviews with microfinance borrowers and explored how much they knew about their loans and microfinance institutions. It turned out that borrowers had little idea about their loan conditions such as interest rates and administration fees they had been paying. Even if some had information about their loans, it was generally outdated. Therefore, borrowers were not aware of any difference between the loans offered by the eight major microfinance organisations.

Subsequently I had interviews with local branch managers of the eight major microfinance institutions operating in Mtongwe. The eight major microfinance institutions are as follows: Rafiki, Cooperative Bank of Kenya, Equity Bank, Faulu, Milango, Kenyan Women for Financial Trust, Yefu Microfinance Trust and Friends for Life. The first five are profit-making organisations, while the last two are non-profit-making groups. Through interviews with these microfinance organisations, I found out significant differences between their loan conditions. For instance, depending on microfinance institutions, interest rates range from 15% to 24%. Repayment duration also varies from six months to one year. My report that microfinance organisations provide loans with noticeably different conditions shocked borrowers. One borrower seemed slightly upset and said ‘I am changing my bank!’. Another also said ‘this information widened our horizon about loans. We did not know how different interest rates were! ’.

The causes of information asymmetry

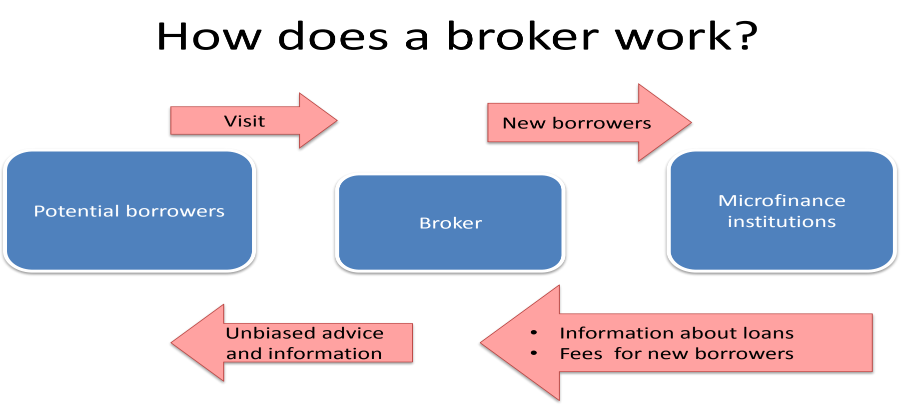
This information asymmetry stems from the following two reasons. First, some microfinance institutions are not adequately transparent and honest to their borrowers. Microfinance institutions, especially those charging high interest rates, are often reluctant to frankly talk about their loan conditions. When I visited a branch manager of Cooperative Bank of Kenya, she tried to hide interest rate (which was the highest, 24%), saying “that is secret” and “I can’t tell you about it”. Interest rates of loans are publicly open information in general. Some Kenyan microfinance institutions showed such an attitude which can be seen as dishonest and deceiving towards their borrowers.

Furthermore, Kenyan microfinance institutions use flat interest rates which generally appear lower to borrowers than they actually are. Flat interest rates are effectively higher than reducing balancing interest rates, which are generally considered as more accurate way of calculating interest rates in accordance with how much borrowers owe to banks. Therefore, this practice blinds those who lack the knowledge of finance. I omit the detailed explanation about this practice here, but refer to this paper[i] for further detail of this problem.

Secondly, borrowers completely lack the idea that microfinance organisations offer loans with different condition and that they should be compared with each other. This is exacerbated by the fact that microfinance organisations do not know about the detailed loan conditions of each other. Therefore, they do not compare their own loans with the loans of other microfinance organisations when they attempt to outreach and get new borrowers.

Suggestion

One provision is to facilitate market competition among microfinance institutions. It promotes microfinance institutions to lower their interest rates and become more transparent by establishing a broker who independently compares each microfinance institution. The independent broker considers the needs and repayment abilities of those who are willing to borrow loans and introduces an appropriate loan to them. Microfinance institutions pay some fees for the broker for bringing new borrowers. The broker gathers much information about loans of microfinance organisations and gives unbiased consultation to potential borrowers on the basis of professional analysis. This helps potential borrowers to make a decision with more accurate and comprehensive information about loans available to them. Microfinance institutions are discouraged to blur some information and use the flat rate interest rate to blind borrowers because the broker is an expert of microfinance and independently assist potential borrowers to choose the most appropriate loan for themselves. Moreover, microfinance institutions are urged to compete more intensively in terms of loan conditions because potential borrowers become more able to compare different microfinance institutions. Such a brokering organisation can work to resolve the problem of information asymmetry in the microfinance market and further the more competitive and transparent market environment. The potential limitation of this approach is that there is no mechanism to check the neutrality of the broker. However, it can also be argued that this business model places the broker under constant pressure of being neutral in order to keep trust from potential borrowers.



[1] MFTransparency (no date) *Flat vs Declining Balance Interest Rates*, available online at http://www.mftransparency.org/pages/wp-content/uploads/2011/10/Article_Flat-vs-Declining-Balance-Interest-Rates.pdf, accessed 14 February 2011.