

The Need for Pricing Transparency in Microfinance

Microfinance has long been a highly transparent industry, and rightly proud of it. But sadly, the true price of our loan products has rarely been accurately measured or reported. The next stage in the growth of microfinance will require a new level of understanding and openness about the costs of lending in small units and transparent communication of the prices charged to cover those costs. An industry born to displace the moneylenders by providing low-cost credit to the working poor needs to ensure that its clients have clear information about the cost of the money they borrow.

Standards for Disclosure

Due to the challenges of interpreting and comparing prices of financial products, commercial lenders in many countries are required to state true product pricing using standards such as the APR (Annual Percentage Rate) formula mandated forty years ago in the US Truth-in-Lending Act. Such laws were enacted to help consumers make informed decisions regarding seemingly comparable loans, when in actuality one loan is significantly more expensive. We currently have the same disparity in the microfinance industry that existed prior to Truth-in-Lending laws. For example, a quoted interest rate of 3% per month can result in an APR between 36% and 96% and beyond. An important question for us to consider is: Shouldn't the same principles of transparent pricing applied within the commercial finance industry in many countries also apply to the microfinance industry?

Shouldn't the same principles of transparent pricing applied within the commercial finance industry also apply to the microfinance industry?

Non-transparent pricing in microfinance has evolved and spread for two reasons:

1. First, there is no single market interest rate for micro-loans. All in the industry recognize that interest rates on micro-loans must be higher than interest rates on larger commercial loans, but it is seldom discussed or recognized that there really is no single "market rate" for micro-loans. In a market where all MFIs deal with the same cost structures, the smaller the micro-loan, the higher the interest rate necessary for that MFI to cover the costs of that loan in order to achieve sustainability. In order to be sustainable, a loan of \$100 must carry a much higher interest rate than a loan of \$1,000. Due to the challenges of explaining why MFIs need to charge higher interest rates than the commercial sector, and to charge the *highest* interest rates to the *poorest* clients, the easier alternative has been to use pricing methods where the quoted price appears significantly lower than the actual price.
2. The second reason for the perpetuation of non-transparent pricing is that once the industry began widely employing confusing product pricing, it became very difficult for any one MFI to convert to transparent pricing. To do so would leave that MFI advertising what appeared to be the highest price in the market, even though their true price could actually be the lowest. As a result, the vast majority of MFIs practice non-transparent pricing even though many would prefer to do otherwise.

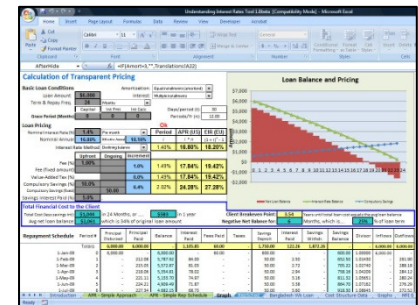
When MFIs are operating in a very opaque pricing environment – where nobody really knows how the price of one

product compares to the price of another product – there exists a very real opportunity for an MFI to charge a price that generates high short-term profits but does harm to its clients. This is a bad situation for the poor and a bad situation for the microfinance industry. High profits generated off of the poor by charging high non-transparent prices can create a very bad public image for the microfinance industry and result in a strong backlash.

Implementing Transparent Pricing

Recognizing this reality, the industry has been in intensive dialogue about the issue, and several movements are underway to address non-transparent pricing. One of these is the “Campaign for Client Protection” that began after an April 2008 conference that produced the “Pocantico Declaration.” Transparent and fair pricing is one of the six core principles advocated in the campaign.

The second effort is MicroFinance Transparency, a non-profit agency that addresses pricing transparency through two joint activities. *MFTransparency* collects product prices on all micro-loan products around the world and reports those prices by a common, objective measurement system. Second, *MFTransparency* has also undertaken the equally important role of developing and disseminating straightforward educational material to enable all microfinance stakeholders to better understand the concept and function of interest rates and product pricing.



We believe that an industry-wide effort to practice transparent pricing is essential to the long-term survival, growth and effectiveness of the microfinance industry.

The mainstream public media is already reporting the level of interest rates typically charged in microfinance. What was little known just a few years ago is now publicly-available knowledge, but there is little explanation or understanding of why microfinance interest rates are higher than previously believed, or why there is significant variation in interest rates among different institutions. What non-transparent pricing has kept hidden for years is no longer hidden. We must create a forum for the industry to report – in a clear, consistent and fair fashion – what actual interest rates are and why interest rates in competitive microfinance markets need to be higher than in commercial finance.

By practicing pricing transparency we can contribute to building a healthy and vibrant market for microcredit products in each country by providing a valuable component necessary for free and competitive markets to develop – transparent, open communication about the true cost of our products. By doing this we can make sure that our micro loan clients receive the same information that we expect to receive when we take out a loan for ourselves.