

# African Microfinance Pricing Transparency Leadership Forum Discussion Insights: The Debate about Official Pricing Disclosure Formulas

The African Microfinance Pricing Transparency Leadership Forum, which took place in Nairobi in October 2011, gathered representatives of 24 different African countries as well as industry experts from other regions around the world. More than 120 participants, primarily policymakers, regulators and microfinance institution (MFI) network representatives, tackled some of the most complex issues that the microfinance industry faces in facilitating transparent pricing.

One of the three main themes of the African Pricing Transparency Leadership Forum was Pricing Calculation. Training sessions given by *MFTransparency*, as well as a plenary discussion moderated by Moses Ochieng of CGAP/DFID and led by Ghépié Anin of BCEAO and Gladys Chongo Mposha of Bank of Zambia, launched an ongoing debate among participants about what an official pricing disclosure formula should include. This article provides insights from this debate, highlighting the most essential issues to be addressed to establish widespread agreement on this critical element of pricing disclosure policy.

## Background

The policy frameworks governing many microfinance markets around the world sometimes include an official formula for calculating and disclosing the prices of microloans. Typically this official formula specified by legislation implemented by the regulatory agency tasked with governing the microfinance market, and is adopted for multiple reasons including:

- Client protection
- Improved reporting standards for microfinance institutions
- Overall increased transparency in the disclosure of the prices of microloans

The official legislation will specify:

- Formula for calculating the official price and how to apply the formula
- What types of institutions and credit products the official formula applies to
- How the official price must be communicated (e.g. via loan documentation, reports to the regulator, displays on the walls of branch offices) and to whom (egg. borrowers and/or the regulatory authority)

As the goal of this official formula is to institute a standard format for pricing disclosure, typically the formula incorporates standard loan terms and repayment frequencies and takes into account some or all charges in addition to interest.

## Advantages & Disadvantages of Having an Official Formula

Although participants in the Forum generally agreed on the importance of pricing transparency, not all were fully convinced that establishing an official pricing formula is a good way of facilitating transparent practices. The following advantages and disadvantages in particular were discussed:

### *Advantages*

With an effective official pricing calculation formula consumers are protected against excessive rates and also hidden charges. The formula makes it harder for institutions to hide such abusive practices thereby rendering them unable to compete in the market if they continue to apply them. This also implies that prices are widely known throughout the market, both on the part of clients and institutions, enabling competition on the basis of price. Provided that the official formula allows for comparison among the range of loan products available in the market, this increased competition can lead to gains in efficiency and ultimately lower-priced, better-quality products for clients. The availability of this information is valuable for policymakers and regulators as well, who would be much better-positioned to make effective policy decisions if they had access to accurate, comparable information about the prices of credit products.

### *Disadvantages*

Many participants in the forum expressed doubt that an effective formula could be chosen and implemented. Some believed that in order for an official pricing calculation formula to really communicate the true price of microloan products it would have to be too complicated for most institutions to calculate. The reality of most markets is that many microfinance institutions are lacking the skills and resources to effectively apply complicated formulas, so even if the requirement were in place it would have minimal impact. Participants were also concerned with the likelihood of arriving at an official formula that would accurately account for the full range of diversity in the market, in terms of variation across geographies, institution types and product types. Might requiring all institutions to disclose prices according to the same standard cause some prices to appear excessively high? Or suggest that all prices are subject to the same determinants, thereby masking diversity in the market?

Beyond the basic question of whether or not an official pricing calculation formula is a potentially positive policy strategy, participants went on to discuss some of the steps that would go into developing and implementing such a policy.

## What Formula to Choose?

Many questions arise in the process of selecting an official formula, in particular *how* the formula should calculate price and *what components* should be included. This is a topic that participants in the African Microfinance Pricing Transparency Leadership Forum discussed at length.

Some of the most challenging questions surrounding what formula to select involved the following aspects:

- **Term:** Should the official formula communicate price on an annual basis? Monthly? Weekly?
- **Repayment frequency:** Building on the point above, is it appropriate to communicate the official price according to a different term than the repayment frequency? For example, is it a problem for the official price to be calculated on an annual basis if most borrowers make payments on a monthly basis?
- **Compounding:** Should the effect of compounding interest be included in the official pricing calculation formula?<sup>1</sup>

Perhaps still more controversial was the discussion surrounding what elements of pricing should be captured in the official formula. Most participants agreed that the official formula should include both the interest rate and some fees, and that each should be clearly defined. However, participants vehemently disagreed on the question of including several other types of charges to the borrower in an official formula. These include:

- **Insurance:** Should insurance be counted as a cost of the borrower benefits from it? What if the insurance payment goes directly to a third party insurance company rather than to the MFI?
- **Security deposit (compulsory savings):** Should compulsory savings requirements factor into the official price? Although they do require a borrower to outlay money at the start of the loan term, the borrower benefits by having savings.
- **Third party fees:** What about fees that a borrower pays as part of the loan that do not go to the MFI, for example legal fees? Insurance and taxes often fall under this category as well.
- **Taxes:** If the government requires borrowers to pay taxes on their loans, not the institution, should this be included in the official formula?
- **“Optional” fees:** Some institutions charge fees for additional services along with credit that are technically “optional” but 99% of borrowers opt to take them. How might an official formula reflect this?

<sup>1</sup> This question typically refers to the question about whether to use an Effective Interest Rate (EIR) calculation, which typically accounts for the effect of compounding, or an Annual Percentage Rate (APR) calculation, which simply annualizes the cost of the loan.

- **Penalty fees:** If an official formula only includes expected charges or payments, there is no way of knowing which institutions charge steep penalty fees for late payments.

The discussion of whether or not to include these elements in an official price formula raised additional, more complex issues, such as should all charges even be allowed? Should some of them be limited? What is the difference between requiring disclosure of *pricing* versus disclosure of *profits*? Should institutions also disclose their own costs, and if so how? How much importance should be placed on selecting an official formula for *calculating* prices versus instituting standards for *disclosing* prices?

Amid all these questions one important point became clear: policymakers and regulators need ways of determining what approaches to establishing official rates are optimal. Whether through collecting information on industry players, hosting meetings and discussions to address this issue or conducting pointed analysis of existing information, many regulators agreed that there is a need in their market for understanding the environment for pricing transparency better.

Participants also agreed that the official formula selected should take into account the unique characteristics of the local market it applies to, further emphasizing the need to understand this context, and implying that we should expect official pricing disclosure formulas to vary across countries. Maybe there is no single right answer to the question of which formula is best.

## Common Questions & Challenges

Beyond the theoretical issues raised by the discussion of what should be included in an official pricing formula, participants in the Forum also shared their experiences in facing many practical issues in establishing and enforcing pricing disclosure. The following section outlines some of the most commonly discussed issues.

### *Self-Regulation versus External Regulation*

Many participants in the Forum expressed the opinion that some aspects of pricing disclosure should be enforced through self-regulation and others through external, official regulation. Self-regulation could, for example, take the form of an official pricing formula adopted through Codes of Conduct or other standards agreed upon through professional associations or MFI networks. Some argued that given the limited capacity of some regulatory agencies, as well as knowledge of the sector on the ground (in some cases), some aspects of facilitating pricing transparency might be best executed through self-imposed standards. Others argued that “self-regulation” in practice can become more like collusion, and that since MFIs often benefit from opaque practices the incentives are not in place to make self-regulation effective.

One important benefit to at least a partial self-regulatory approach is that in many microfinance markets a significant portion of the market is not under the purview of the regulatory authority. If a regulator were to require only regulated institutions to adhere to an official pricing formula, allowing unregulated institutions to continue to use non-transparent practices, this could create a significant market



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distortion. In addition, it could actually make the environment for clients worse, creating more variation in pricing and more confusion about which products represent the best option.

#### *Standardized Loan Documentation*

Many participants at the Forum raised the point that an official pricing disclosure formula is only as powerful as the extent to which the standard rates are disclosed. When discussing what pricing components should be included in an official pricing formula, it may be equally important to define which components are disclosed through loan documentation given to borrowers. For example, while many institutions disclose interest rates, loan terms, installment amounts and repayment frequencies, it is less often that information about fees, insurance charges, compulsory savings and interest rate calculation methods are included in repayment schedules and loan contracts. If an official pricing disclosure formula requires institutions to report an APR or EIR to the regulator, shouldn't they also be required to share it with the borrowers? If knowing the total cost of credit is not enough for policymakers and industry professionals, why should it be enough for borrowers?

In addition to the content of pricing information disclosed on loan documentation, the manner of disclosure was discussed as well. Many participants advocated the requirement of a standard template to prevent institutions from burying important information deep into long documents or to present it in confusing ways. Templates also make it much easier for clients to “shop around” and make comparisons between products.

#### *Limitations of Technical Capacity*

Concerns about the technical abilities of microfinance institutions to absorb new requirements are always present but particularly acute when it comes to pricing calculations, a topic that even top experts struggle with. Much of the discussion about official pricing formulas centered on the challenge of preparing institutions to adhere to any new requirements. All agreed that training and capacity building would be necessary in order to make the use of any official formula feasible. Other ideas for supporting the process included the provision of software and tools for MFIs to use to convert their current calculations to a new official formula. This of course begs the additional question of whose responsibility it should be to provide such technical assistance and also to fund it. What should the role of the regulator be relative to that of donors? Investors? Technical assistance providers?

In addition, to backstop the implementation of new policy it is important to educate the clients themselves. An informed public, who is aware of their rights and the standards of service they are entitled to, can be a valuable component to the success of a new policy. The question of educating clients, however, raised even more questions and difficulties than that of educating institutions.

### *Making the Switch from Flat to Declining*

Adjacent to the discussion of what type of formula might constitute an ideal official pricing disclosure formula, participants discussed the question of the flat versus declining balance methods of calculating interest extensively<sup>2</sup>. Most agreed that any official formula in place should use the declining balance method, and possibly even forbid the use of the flat method, but they also expressed concerns about the process of actually implementing such a requirement. How can we get an entire industry to shift from using predominantly flat to all declining balance rates? Is there a way to ease into this? Perhaps of most concern, once we require institutions to switch to the declining balance rate, what if we discover that prices are much higher than we thought? What kind of backlash might result from politicians, media, funders and the general public?

These are questions that *MFTransparency* is highly focused on, as we are strong advocates for the banning of flat interest rates. Our entire data collection methodology centers on the fact that we publish prices for the market as a whole at the same time. This way if the true prices are a surprise to the industry, at least they undergo the process of becoming transparent together rather than singling out a few institutions. In addition, we provide helpful resources targeted specifically at the issue of flat interest, including an article explaining this dynamic in microfinance, a model repayment schedule showing how the declining balance rate can be communicated to borrowers clearly and simply and a price calculator that enables policymakers and regulators as well as institutions to translate flat prices into declining to see how they will appear once converted.

### Country Examples

Through the course of the discussions surrounding official pricing formulas, many country delegations shared descriptions of how pricing disclosure is required in their own local markets. The following are some examples of policies that were mentioned in discussions, as overheard by *MFTransparency* team members:

- **BCEAO:** In the WAEMU countries institutions lend under a price cap and must disclose prices according to an official rate, an Annual Percentage Rate (APR) referred to locally as *Taux Effectif Global (TEG)*.
- **Ethiopia:** Previously a price cap was in place but now the regulator maintains a policy of self-disclosure.
- **Kenya:** Policy requires the disclosure of Total Cost of Credit (TCC) but not Annual Percentage rate (APR). Along with repayment schedules, this information must be reported to the regulator but is not shown to the public.

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<sup>2</sup> Through the flat balance method of calculating interest the borrower pays interest on the initial loan amount throughout the loan period. Through the declining balance method, the borrower only pays interest on the loan amount they have in their possession as they repay principle over the course of the loan term. The declining balance method is widely considered to be fairer and more transparent because the borrower only pays interest on the money they have at their disposal.

- **Liberia:** There is no official formula but nominal rates are published publicly, as Total Cost of Credit (TCC) and including some fees.
- **Malawi:** Institutions are required to report Effective Interest Rates (EIRs) to the regulator on a quarterly basis. There is no official formula yet for disclosure to clients, but information such as installment amounts and nominal rates must be on display in MFI offices.
- **Uganda:** There is no official formula but nominal rates and charges must be disclosed. This applies to banks and deposit-taking institutions. There are no sanctions in place for institutions that do not report.
- **Zambia:** Regulation requires that the Total cost of credit (TCC), the Annual Percentage Rate (APR) (including the effect of compounding), the nominal rate and some charges be disclosed. Insurance is specifically excluded from this formula. This information is published by the regulator in tables by loan amount and term, rather than averages by product and amount

## Strategy for Successful Implementation

The question of choosing an official pricing formula is a complex one. It was an important issue to raise at the African Microfinance Pricing Transparency Leadership Forum, and a combination of the opening discussion and roundtables that followed yielded many valuable insights.

Once an official formula has been selected, participants discussed many challenges to its implementation. The following are three of the core themes discussed at the event, which should form the foundation of the strategy for developing and implementing an official price formula:

### *Training and Capacity Building*

Even the best decision regarding the implementation of an official formula can only be as good as the framework in place for applying it. Training, capacity building, technical assistance and education are needed at all levels. Policymakers and regulators must be informed about the reality of pricing in the market in order to make good policy decisions, networks must be informed about new policies in order to support institutions in implementing them and the institutions themselves must be capable of calculating a new pricing formula in order to effectively adhere to disclosure requirements. In addition, educating borrowers and the media will help to ensure that the intention of an official formula comes to bear, facilitating widespread understanding of pricing. Regulators and policymakers can provide tools and software to make the process of adopting new formulas simpler.

### *Coordination between Stakeholder Groups*

Particularly as it relates to the previous point, coordination between different stakeholder groups is essential for the implementation of all types of new policy requirements. Understanding of the different perspectives of institution, regulators and borrowers is essential for developing policies that benefit all. In addition, each group has a role to play in making this a practical success. For example, technical assistance providers can train institutions on how to calculate prices using a new official formula. Donors can consider funding financial education programs for clients and investors can support regulators in enforcement by requiring their partners to use the official formula as well as report their rates directly.



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Networks can act as a liaison between these groups to facilitate discussion and ensure that the perspective of each is understood.

#### *Pricing from the Client Perspective*

While not all participants in the forum necessarily expressed this view, it is *MFTransparency's* position that a truly transparent price takes into account all costs paid by the borrower in order to access credit, regardless of whether the institution benefits from them or not. We believe that official pricing formulas should also take this perspective. Institutions should be required to disclose all costs a borrower is likely to face when accessing a microloan. In addition, institutions should be required to disclose this information in multiple formats so that in addition to the official rate borrowers also know their installment amounts, repayment frequency, any late payment penalties, etc. We believe that through putting the client perspective first in terms of pricing disclosure, all stakeholders in the market benefit.



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