

Microfinance TRAPS

*The Microfinance Transparent
Pricing Supervision Handbook*

June 2013

A publication sponsored by

Microfinance Transparency

The microfinance industry continues to grow into one that is dynamic and far-reaching. It is applied all over the world in many creative forms, and with the participation of many types of stakeholders. MicroFinance Transparency is a NGO established in 2008 to promote the welfare of poor micro-entrepreneurs, and to promote the integrity of microfinance as a poverty alleviation practice.

Microfinance has long been highly transparent in some areas, but due to complications of market conditions and lack of regulation, the true price of our loan products has never been accurately measured or reported. For this reason MFTransparency believes there is a need to present information on credit products and their prices in a clear and consistent fashion. At the same time, MFTransparency sees an opportunity to provide education on the considerations microfinance Institutions (MFIs) face regarding interest rates and product pricing.

Since MFTransparency's launch in July 2008, 912 industry leaders, including MFIs and Apex Banks currently serving 60 million clients worldwide, have signed the endorser statement, and over 500 institutions have shared their pricing data on 2,000 loan products currently held by over 60 million clients.

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Planet Rating

Planet Rating is a global rating agency specialized in microfinance. Its role is to support the development of a sound microfinance sector in order to bring a positive social change.

Planet Rating was created in 1999 as a department of the international NGO PlaNet Finance in order to accompany the tremendous development of microfinance services and bring the transparency that was needed to harness the growth of the sector. The rating agency grew rapidly and on June 21st 2005, Planet Rating was officially spun off, becoming an independent, private entity registered as a "Société par Actions Simplifiées" under French laws. Planet Rating's shareholders are PlaNet Finance, Caisse des Dépôts and Consignations, Coface, Viel & Compagnie, LMSR.

Headquartered in Paris, Planet Rating operates in all regions of the world through its network of 4 regional offices located in Lima (Peru), Dakar (Senegal), Nairobi (Kenya) and Manila (the Philippines). It employs 20 people including 15 full-time analysts. Planet Rating has conducted over 700 evaluations and rating missions for 450 MFIs in more than 80 countries.

Planet Rating's evaluation and rating services include:

- Microfinance Institutional Ratings (using the Smart GIRAFE methodology)
- Social Performance Ratings
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- A subscription service to its rating reports

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Chapter 1 - Pricing Calculation

The price of a loan is a confusing subject, for many reasons, as this handbook will describe. Price is often assumed to be the interest rate charged, but that is far from the case. This chapter will describe various complications of interest, and the following will detail other elements that add to and affect the true price of a loan.

Section A - The only valid approach to interest rates

“Interest is the cost of borrowing money; the price that a lender charges a borrower for the use of the lender’s money” (Corporate Finance, Vernimmen). In other words, the concept of interest on a loan can be understood as renting. Similar to renting a home, the interest charged on a loan is the price of renting money, i.e. the amount the borrower pays the lender for the use of money for a given period of time. However, it is extremely important to realize that in almost all loans, the borrower has a variable amount of money that he is renting and for a variable amount of time. While he progressively repays his loan, his loan balance varies, meaning that ***the actual amount of money rented is not the same throughout the course of the loan.***

The amount of interest paid on a loan depends both on the interest rate stated (the “nominal interest rate”, expressed for a period of time) and on the method used to calculate it. Two main techniques are common within the microfinance industry for calculating interest: the “declining balance” method, also known as “reducing balance”, and the “flat” method, where interest is charged on the original loan amount, rather than the current loan balance. This section of the handbook explains why ***declining interest is the only conceptually valid approach to interest rates*** and, as a result, why other options are improperly called interest rates, resulting in misleading and non-transparent pricing.

The declining balance calculation method: the only valid approach

Using the declining balance method, the ***borrower is paying interest on the actual money he has in hand at any given time***, as interest calculation is based on the outstanding loan. As the borrower repays installments, the remaining loan balance declines over time and interest is charged only on the loan amount that the borrower still holds.

The declining balance interest rate is the only approach that properly reflects the definition of an interest rate given above. In recognition of this, ***most countries that have passed laws on the way for financial institutions to calculate interest rates have enforced the use of the declining balance*** calculation method, and prohibited other options such as the “flat” method - described below.

There is no such thing as a “flat interest rate”

In the absence of any legislation on the matter, many financial institutions are prone to use the so-called “flat” calculation method, because the quoted “interest” figure is much lower than the true price and sounds more attractive to the client. When using this method, in each installment, the borrower repays part of the money borrowed (principal), and an additional amount (called “interest”) calculated on the initial amount received rather than on the money s/he has had in hand since the last installment. Consequently, these amounts do not correspond to the definition of an interest rate, but more resemble a fee.

More broadly, ***any fee paid on a loan and calculated on the initial loan amount should not be called interest.*** These fees would be better described as commissions on the initial amount, with a payment spread across the loan term.

“Deducted up-front interest”

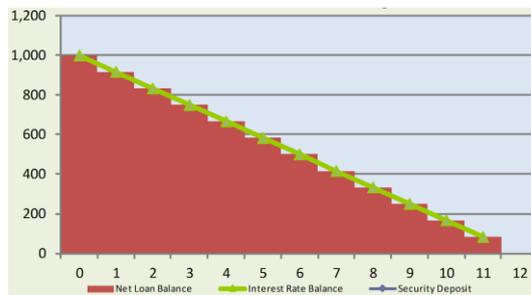
Another misleading approach sometimes used in the microfinance industry is the “up-front deduction of interest”. Once more, this computation method is not in line with the definition of an interest rate. As interest is deducted from the amount disbursed to the client, using this method ***the borrower not only pays interest on money s/he doesn't have in hand during the entire loan term, but on money s/he has not even yet received.***

Declining interest vs. “flat” and “up-front” commissions

These graphs show the impact of different pricing options for a 12 month loan of \$1,000 with monthly payments. The red area represents the outstanding loan balance, decreasing over time as the loan is paid back to the institution. The green line represents the figure upon which interest is charged.

Declining interest rate

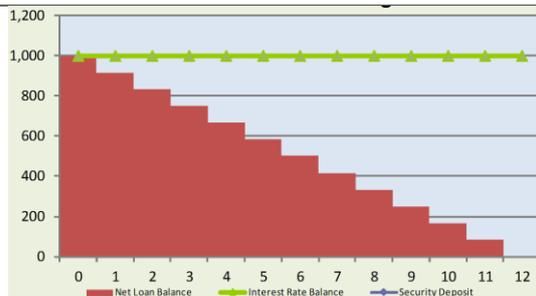
- ✓ Accurate reflection of the cost of borrowing
- ✓ Equal to the actual price
- ✓ Borrower pays interest just on the money they hold



Nominal rate
12%
APR
12%
TCC
\$65
Average net loan balance
\$542

“Flat”

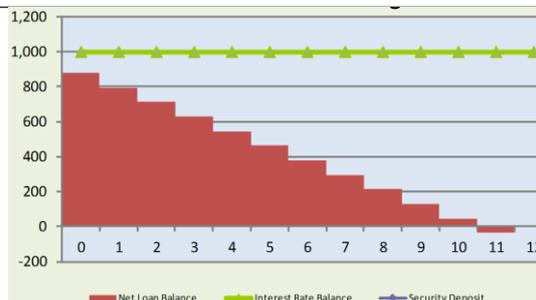
- ✗ Wrong terminology: this is a commission and not an interest rate
- ✗ Lack of transparency: loans look cheaper than they really are



Nominal rate
12%
APR
21.46%
TCC
\$120
Average net loan balance
\$542

“Up-front”

- ✗ Wrong terminology: this is a commission and not an interest rate
- ✗ Lack of transparency: loans look cheaper than they really are



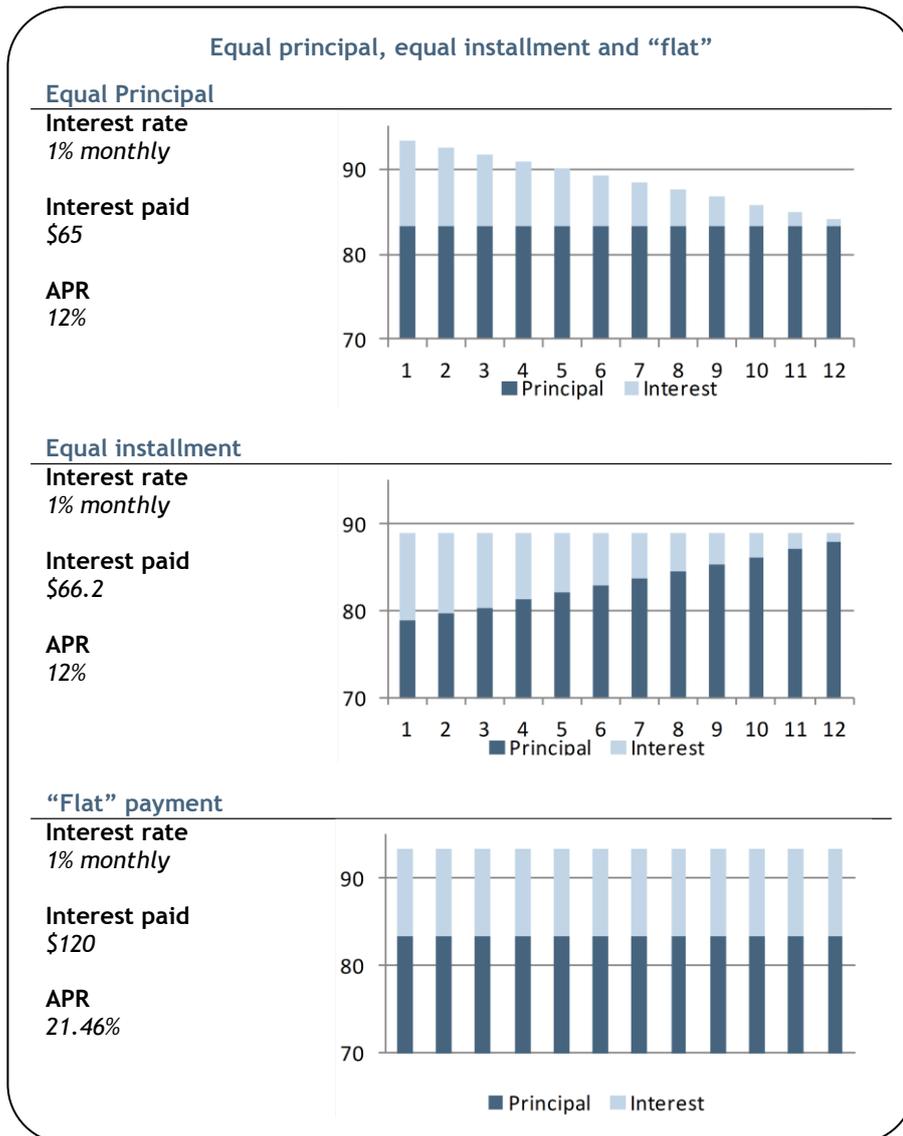
Nominal rate
12%
APR
24.28%
TCC
\$120\$
Average net loan balance
\$422

Why is the flat calculation so commonly used in the microfinance industry?

It is sometimes argued that “flat” computation can have its virtues from the client’s perspective. For example, “flat” rates make it easier for clients to calculate the amount due: borrow \$1000 at 2% per month flat for 10 months, and you know each installment will be \$100 plus \$20 of interest. It is not as simple to calculate interest due on declining balance, as it usually requires more complex calculation. As shown in the table below, declining balance interest is calculated on the outstanding balance which varies each month, resulting in installments that can vary for each payment.

The “flat” method allows financial institutions to advertise “interest” rates that are in fact about half of the real price. To most borrowers, especially those with minimal financial education, the flat rate seems cheaper. The use of this calculation method is prevalent in markets where transparency requirements have not been sufficiently legally defined, and/or where mechanisms to supervise and enforce transparency have not yet reached maturity. Even if it is believed that “flat” computation can have its virtues from the client’s perspective, there are other ways to bring the same value while displaying a transparent price.

In reality, *it is possible for institutions, even without a sophisticated MIS, to calculate the declining balance interest rate and communicate payment amounts to clients effectively.* For institutions that are concerned that borrowers may find it difficult to pay a different amount of interest in each repayment period, amortizing principle payments is an effective way to use a declining balance interest rate and still require equal repayment amounts each period. The amount of interest paid is slightly more on the amortized loan but the APRs are the same, because through amortization the borrower repays the loan amount more slowly, and therefore has more time to use the principle amount to generate income.



Section B - Transparent interest rate formulas: APR, EIR and MPR

The true price of a loan is composed of an interest rate and other charges required by the lender. More precisely, as seen in the previous section, an interest rate is not only influenced by the *amount of money the client receives* and the *amount of charges paid in return*, but also by the *amount of time the client has use of that money*, and the *timing of payments*. This section of the handbook explains why timing issues influence prices, and how transparent interest rate formulas take this into account. With some variations, the Annual Percentage Rate (APR), the Effective Interest Rate (EIR), and the Monthly Percentage Rate (MPR) convert all charges borne by borrowers in order to calculate an equivalent declining balance interest rate. As such, they allow comparing the prices of loan products bearing different nominal interest rates, charges, loan terms and repayment schedules.

Understanding the time value of money

Timing matters when discussing pricing. The concept of “time value of money” assumes that *it is preferable to receive a given amount of money today rather than at some point in the future*, everything else being equal. For example the MFI prefers to receive interest payments in advance in order to use this money to make additional loans on which it would earn interest. The client, on the other hand, would prefer to pay all the interest in one single payment at the end of the loan, because he could then use that money in his business for a longer period of time.

Calculating accurate and *transparent interest rates requires a cash flow approach to credit*, combining disbursements to and from the borrower as well as the particular moment in time at which they take place.

Time value of money: future and present value

The future value **A** of an amount **PV**, when compounded at the interest rate **i** for **t** time intervals is:

$$A = PV * (1 + i)^t$$

Rearranging the formula, we can see that the present value for a **single monetary transaction** is:

$$PV = \frac{A}{(1 + i)^t}$$

The following formula adapts the present value formula to give the **cumulative present value** of a string of future cash flows:

$$PV = \sum_{t=0}^n \frac{A}{(1 + i)^t}$$

Understanding the discount rate method

APR, EIR and MPR can be defined as *the declining balance interest rate that would make the present value of the loan received by the client equal to the present value of the installments paid by the client*. In other words, the Present Value formula (see box) is applied to both advances “**A**” (i.e., the loan disbursements received by the client) and to the installments paid by the client “**P**”. This is shown in the following formula, called the **Discount Rate Method**. This formula calculates a *per unit period* interest rate for the smaller unit of time of the loan, i.e. the smaller period of time between two transactions. This is usually equivalent to the repayment period: daily, weekly, bi-weekly or monthly.

Time value of money: the discount rate method

$$\sum_{k=1}^m \frac{A_k}{(1 + i)_k^q} = \sum_{j=1}^n \frac{P_j}{(1 + i)_j^t}$$

A_k : amount of the kth advance;

q_k : number of full unit-periods from the beginning of the term of the transaction to the kth advance;

m : number of advances;

P_j : amount of the jth payment;

t_j : number of full unit-periods from the beginning of the term of the transaction to the jth payment;

n : number of payments;

i : percentage rate of finance charge per unit-period, expressed as a decimal equivalent.



We can apply this formula to a simple loan example of \$1,000 for 12 months with monthly interest of 1%, and equal monthly installments. The nominal values of the disbursement and repayment schedule can be seen in the two left columns of this table, while the values discounted at a 1% discount rate can be seen in the two right columns.

Period	Nominal Values		Discount $i = 1\%$		Discounted values	
	Disburse	Repay	Divisor	Disburse	Repay	
0	1000.00	0	$(1 + 1\%)^0 = 1.0000$	1000.00		
1	0	88.85	$(1 + 1\%)^1 = 1.0100$	0	87.97	
2	0	88.85	$(1 + 1\%)^2 = 1.0201$	0	87.10	
3	0	88.85	$(1 + 1\%)^3 = 1.0303$	0	86.24	
4	0	88.85	$(1 + 1\%)^4 = 1.0406$	0	85.38	
5	0	88.85	$(1 + 1\%)^5 = 1.0510$	0	84.54	
6	0	88.85	$(1 + 1\%)^6 = 1.0615$	0	83.70	
7	0	88.85	$(1 + 1\%)^7 = 1.0721$	0	82.87	
8	0	88.85	$(1 + 1\%)^8 = 1.0829$	0	82.05	
9	0	88.85	$(1 + 1\%)^9 = 1.0937$	0	81.24	
10	0	88.85	$(1 + 1\%)^{10} = 1.1046$	0	80.43	
11	0	88.85	$(1 + 1\%)^{11} = 1.1157$	0	79.64	
12	0	88.85	$(1 + 1\%)^{12} = 1.1268$	0	78.85	
TOTAL	1000	1066.2		1000.00	1000.00	

It can be seen that the client receives \$1,000 and pays back a total \$1,066.19 over 12 months. The center column shows the denominator of the PV formula when the monthly discount rate is 1.0%. The divisor for Period 0 is $(1.01)^0 = 1.000$. The divisor for Period 1 is $(1.01)^1 = 1.01$. The divisor for Period 2 is $(1.01)^2 = 1.0201$. The right hand columns divide the disbursements and repayments for each period by the period's divisor and result in the discounted present value of those amounts. In summing up the total discounted present values of the disbursements and repayments, one sees that they are both equal to \$1,000, as required by the Discount Rate Method equation.

The process to find “i” is an iterative process where different values are tried until the sum of disbursements and repayments are equal. For example, trying $i = 0.9\%$ gives a discounted present value of \$1,006.35 for the repayment stream. Trying $i = 1.1\%$ gives \$993.71. With $i = 1.0\%$, the value is exactly \$1,000 and equal to the discounted present value of the disbursement stream. This process can be easily run under Excel with the help of the functions IRR and XIRR which perform automatically this iterative process and provide an accurate answer to several decimals.

Calculating the Annual Percentage Rate (APR)

The Annual Percentage Rate (APR) is a unit rental cost which indicates the cost to borrow money for one year. For instance, an APR of 30% means it would cost you \$30 to borrow \$100 and keep the entire \$100 for one full year. The APR is an essential figure to compare the true cost of different loan products as it converts the array of charges made for a loan (interests, fees, etc.) into a simple, declining balance interest rate that has an equivalent cost.

As mentioned, the above formula provides “i”, the interest rate per unit of time (i.e. weekly or monthly). **The APR method converts this weekly or monthly interest rate into what would be called an annual rate** that doesn't take into account the effect of compounding. It is simply the period interest rate times the number of periods in a year, e.g. a monthly rate of 1.0% becomes an APR of 12.0%.

$$APR = i \times n$$

Calculating the Effective Interest Rate (EIR)

Another common approach to transparent prices is the Effective Interest Rate (EIR), which is the European Union standard and which is also used in a large number of countries around the world. In the basic approach, the APR and EIR share the core approach of determining the per unit period interest rate for the payment frequency but differ in the way they convert that monthly interest rate into an annualized rate.

The equation to solve for the EIR formula differs from the APR in that the periodic rate is annualized using compounding:

$$EIR = (1+i)^n - 1$$

The *EIR is more precise in financial terms, taking into consideration the effects of compounding*, i.e. the fact that for each period, interest is not calculated on the principal, but on the amount of the previous period, including capital and interest. This reasoning is easily understandable when looking at savings: in the example below, interest is capitalized every month, and every month the saver earns interest on the interest from the previous period. As an effect of compounding, the interest earned over a year represent 26.82% of the initial amount, instead of 24%, the monthly 2% interest rate simply multiplied by 12.

Month	Amount beginning of month	Interest rate	Amount end of month	Interests earned
1	1000.0	2%	1020.0	20.0
2	1020.0	2%	1040.4	20.4
3	1040.4	2%	1061.2	20.8
4	1061.2	2%	1082.4	21.2
5	1082.4	2%	1104.1	21.6
6	1104.1	2%	1126.2	22.1
7	1126.2	2%	1148.7	22.5
8	1148.7	2%	1171.7	23.0
9	1171.7	2%	1195.1	23.4
10	1195.1	2%	1219.0	23.9
11	1219.0	2%	1243.4	24.4
12	1243.4	2%	1268.2	24.9
Total interest earned				268.2

If we consider borrowings instead of savings, *the compounded interest rate reflects the opportunity cost for the borrower not to be able to invest the interest he pays to the lender into an asset generating the same percentage of return*. As such, investment opportunities are rarely available to individual borrowers, as opposed to institutional investors; the EIR might be more precise in financial terms but not necessarily the most accurate reflection of the true cost paid by a microfinance borrower.

In addition, compounded rates are very confusing to understand for the consumer. The difference between interest rates quoted using the APR and EIR formula diverge more as the number of compounding periods in the year increase and as the period interest rate increases, i.e., loans with interest calculated quarterly will have APRs that are close in both formulas, but when interest is calculated weekly, or even daily, the two APRs can give quite different figures.

1%	APR	EIR	Multiplication factor
Monthly	12.0%	12.7%	x 1.056
Weekly	52.0%	67.8%	x 1.303
Daily	360.0%	3495.0%	x 9.708

Calculating the Monthly Percentage Rate (MPR)

The MPR is the monthly equivalent of the APR. It can be expressed as a similar formula, i still being the percentage rate of finance charge per unit-period, but n being the number of payments per month.

$$MPR = i \times n$$

While the use of annual interest rates is more common, it is actually an arbitrary time horizon, and interest rates could as well be expressed in century or millenary rates. But in most cases, years seem a relevant yardstick. Nevertheless, *in some countries where the usual loan term is weeks or months, the MPR can be a fair representation of the prices paid*, whereas disclosing the annual rate of a 3 month loan would be the equivalent to disclosing a century rate for a 25 years mortgage.

In countries where the disclosed rates have historically been underestimated (due to the use of “flat” monthly or weekly rates, for examples), the switch to APR disclosure could create a shock and generate global mistrust towards financial institutions charging APRs of 80% and even higher, putting the entire market at risk. In such cases, choosing the MPR as the legal transparent calculation formula could be a legitimate option, at least for loans under a certain amount or for a short period of time. Nevertheless, for the same reasons as above, *such a monthly rate is unlikely to be recommended for large banks* providing bigger loans for a longer term. Even though the MPR can easily be converted into APR, having two authorized rates in a country creates a risk of seeing two markets operating in parallel, and among which comparability is not strictly ensured for the clients. Nevertheless, APR or EIR on one side, and MPR on the other could coexist if the use of MPR is limited to small, short-term loans.

Chapter 2 - The hidden costs of credit - what to include in a true price formula

After making clear why only declining balance interest rates should be used (section 1.a), and how only a cash-flow approach to credit allows calculating the true price of a loan with an APR, EIR or MPR formula (section 1.b), this section focuses on the items that need to be included in the cash flow used for an interest rate calculation.

For borrowers, the APR is meant to give the price of renting money for a certain period of time. And as seen earlier, any item that impacts a client's cash flow has an impact on the APR. As a result, ***all the mandatory charges borne by a client in order to obtain a loan must be included in the APR calculation***, considering that from the client's perspective, they are all part of the cost of getting a loan, whether they are labeled as "interest rate" or not.

Commissions, administrative fees, guarantee deposits, compulsory "savings", and insurance: by all means, ***the number of additional non-interest pricing items should be limited***, as their accumulation makes true price less intelligible. And only in a very few cases can these charges be legitimately excluded from the APR calculation.

Section A - Understanding the design of non-interest charges

The issue of banking fees is far from a microfinance-specific curiosity. In countries with a high level of financial inclusion, deposit-taking institutions might be tempted to bury tiny amounts of fees among many lines of monthly operations on a client's current account. In credit-only financial institutions, they often take the form of charges that are not labeled as interest rate but are still compulsory for the client. ***Often presented as insignificant marginal fees, sometimes never heard of before the initial disbursement, those charges can actually have a huge impact on the APR.***

Non-interest charges have a very different impact from one loan to the other depending on the way they are designed. This impact depends on two variables:

- Is the charge a fixed amount or a percentage of the loan amount?
- Is it paid up-front at disbursement, or paid throughout the loan with each installment?

Impact on APR / Transparency		
	Fixed amount	% of the loan amount
Up-front payment	If clients of an MFI pay an <i>up-front fixed amount</i> : The impact on the APR increases dramatically for clients with a smaller loan, and for clients with a shorter loan term.	If clients of an MFI pay an <i>up-front</i> fee equal to a <i>percentage of their loan</i> : The impact on the APR is much higher for clients with a shorter loan term.
On-going payment	If clients of an MFI pay a <i>fixed amount</i> with <i>each installment</i> : The impact on the APR is much higher for clients with a smaller loan, as the charge represents a larger % of their loan amount.	If clients of an MFI pay <i>with each installment</i> a fee equal to a <i>percentage of their loan</i> : The impact on the APR is much higher for clients with a shorter loan term.

From the financial institution's point of view, each one of these options can have its own legitimacy when designing a pricing model. But the very large and variable impact they have on the APR makes them crucial elements to include in the APR in order to obtain a truly transparent price.



The impact of up-front fees

Imagine a standard loan of \$1,000 borrowed at a monthly 1% interest rate: its APR is 12%.

What happens ...

... if we charge a \$100 up-front fee to the same loan ?

The APR increases, as the interest is calculated on \$1,000 when the client has received \$900. Each month, the loan balance on which interest is calculated (the green line) is higher than the actual loan balance in the hands of the borrower (the red area).



Nominal rate

12%

APR

32.88%

TCC

\$165

Average net loan balance

On average, the borrower has had \$442 in his hands, or 44% of the original loan amount.

...if we charge a \$100 up-front fee with a 6 month loan term

Surprisingly, the APR increases whereas the TCC is lower and the average net loan balance is higher, which might lead us to think the borrower has had more money in possession throughout the loan. This is true, but as the loan term is shorter, the borrower has disposed of the money during a shorter period of time, which increases the cost of the loan.



Nominal rate

12%

APR

50.17%

TCC

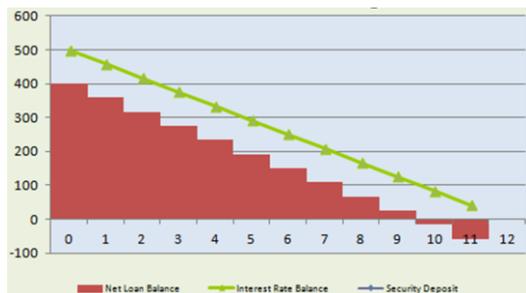
\$135

Average net loan balance

On average, the borrower has had \$484 in his hands, or

...if we charge a \$100 up-front fee with a smaller amount (\$500) over 12 months

The APR increases even more, as the fee represents a larger percentage of the initial loan amount. The difference between the loan balance on which interest is calculated and the money the borrower actually has in his hands is more important.



Nominal rate

12%

APR

57.52%

TCC

\$133

Average net loan balance

On average, the borrower has had \$171 in his hands, or 34% of the original loan amount

Section B - Commissions

In contrast with other charges such as insurance or guarantee deposits, it might be unclear what the purpose of commissions is. Indeed, we expect the price of lending money to be the interest rate, so what are commissions used for?

Actually, the interest rate understood as the price for renting money, covers the opportunity cost for a financial institution (FI) to lend money to a client instead of investing it in another productive asset. But there are significant costs incurred by the institution during the filing/application process before disbursing the loan. In order to pay for this service when the FI incurs the cost, it can be argued that borrowers should pay commissions at the moment of loan disbursement. It should nonetheless be noted that for micro-loans, these costs are much more significant relative to loans size than for big loans. Whereas 1% might cover administrative expense on a big loan, 1% on a micro-loan would not. For this reason, in microfinance, administrative costs are always built into interest rates as a way to spread them over the loan term.

Nevertheless, such *commissions should still be included in the APR calculation. They can have a large impact on the actual price for the client*, since they are usually paid at the beginning of the loan course. This is also needed for strict comparability between FIs, as they can choose to structure their pricing differently; while an institution can choose to charge an initial administrative commission and an interest rate, another one can decide to include the initial administrative costs in the interest rate, resulting in a higher nominal rate but no initial commission.

As the number of costs a FI has to cover is rather limited, *the number of different commissions allowed should also be restricted*, in order not to confuse clients with a long list of fees that increase the cost without stating it in the interest rate.

In addition, any regulation on commissions should be very well designed, as *some kind of limitations can easily be bypassed*.

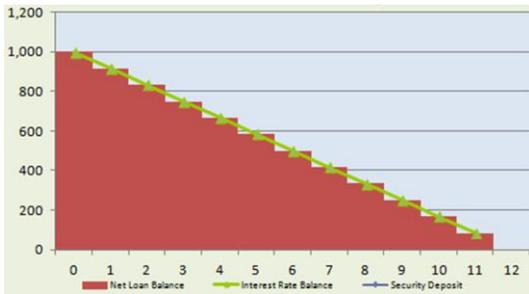
- For example, limiting the amount of commissions allowed on each loan disbursed as an absolute value (for example \$10) could look like a valid option. Nevertheless, financial institutions could be tempted to disburse loans for a shorter period, in order to charge the authorized commission more often for each loan renewal.
- As an alternative, one could consider limiting the amount of commissions allowed as a percentage of the loan amounts. In that case, financial institutions could encourage borrowers to take bigger loans in order to charge bigger commissions, while putting clients at risk of over indebtedness, thus increasing the FI's credit risk. It could also motivate shorter loan terms so that the commissions could be charged more often.
- The only way to avoid the two previous options would then be to state a cap in annualized terms.



Different pricing, same APRs

These three loans of \$1000 borrowed for one year have different pricing structures. But they all have the same 24% APR.

Charging a 2% monthly interest rate only



Nominal rate
2%, monthly

APR
24%

TCC
\$130

Average net loan balance

On average, the borrower has had \$542 in his hands, or 54% of the original loan amount.

Charging a 1.5% monthly interest rate and a \$29.70 up-front fee



Nominal rate
1.5%, monthly

Up-front fee
\$29.70

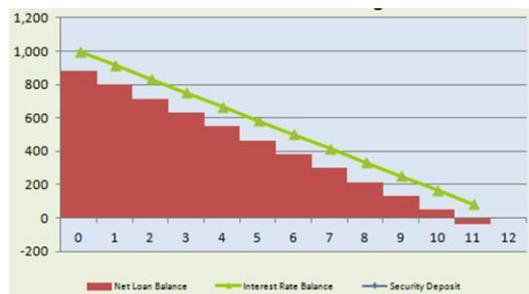
APR
24%

TCC
\$127

Average net loan balance

On average, the borrower has had \$513 in his hands, or 51% of the original loan amount

“Interest rate free”, but with a 11.87% up-front fee



Nominal rate
0%

Up-front fee
11.87%

APR
24%

TCC
\$119

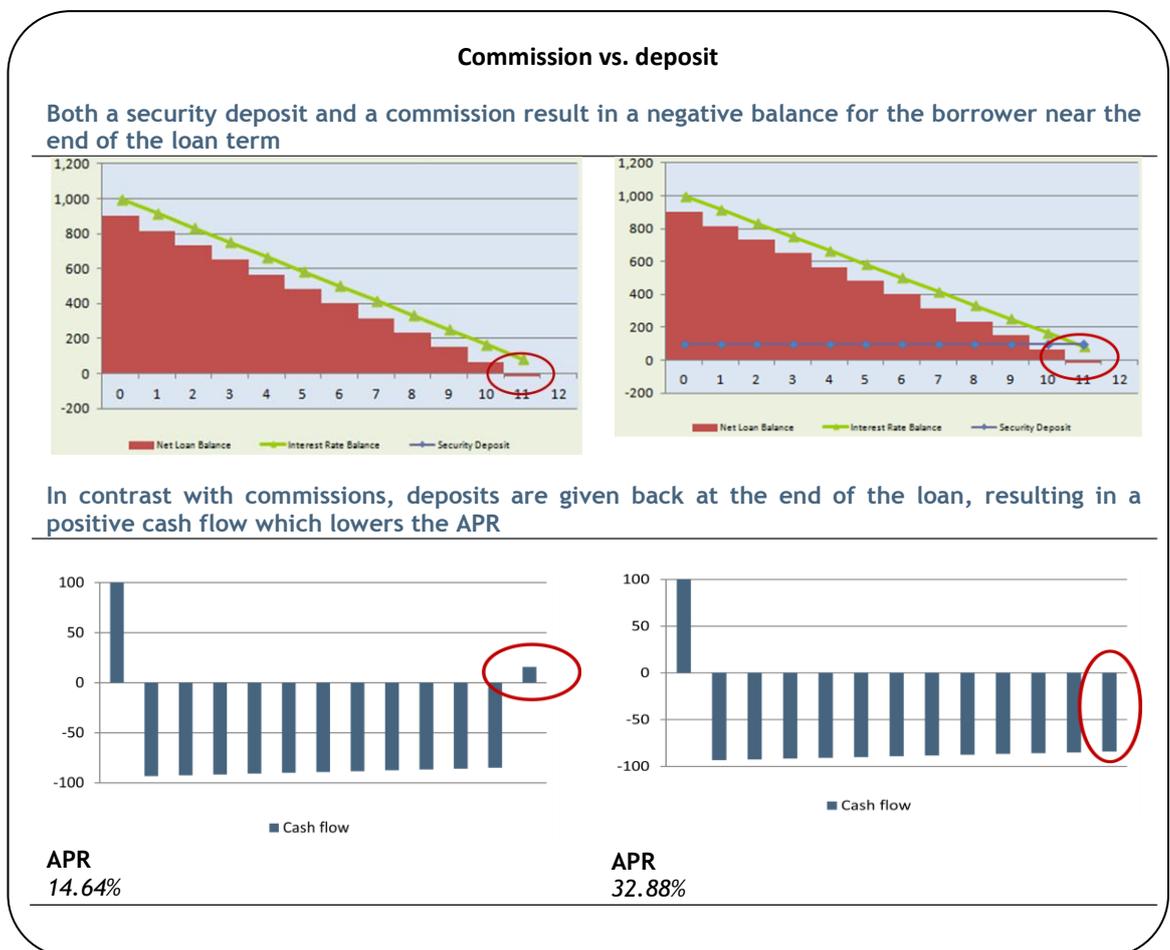
Average net loan balance

On average, the borrower has had \$424 in his hands, or 42% of the original loan amount

Section C - Deposits

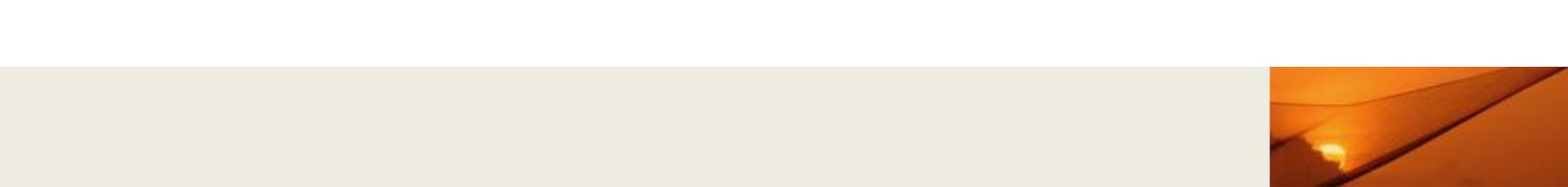
Referred to as guarantee deposits in some countries, or compulsory savings in others, the amounts of money borrowers have to deposit against the disbursement of a loan are; in fact, in most cases a cash collateral, inaccessible to clients during the loan. As such, deposits increase the cost of a loan: in both cases, clients have a negative cash flow at the beginning of the loan that is not accounted for in the interest rate, even if they have a positive cash flow at the end when the deposit is returned.

The only difference in the case of deposits is that clients still own the amount deposited. But as this amount is not accessible during the loan term, the net amount the borrower has to work with is less than the amount on which interest is calculated. Whether a client uses part of the loan to constitute the deposit, or brings in money from savings, the result is the same: the client never had at disposal a portion of the amount of money on which interest is being calculated. What is even worse is that, near the end of the loan duration, the client is still paying interest whereas s/he actually has a negative balance with the bank.



Only in some cases would it make sense not to consider a deposit as part of the loan cost, and; thus, not include it in the APR calculation.

- **When the deposits are not cash.** Financial institutions can accept non-cash assets as guarantee. These can be either physical assets, pledged to the institution, or amounts of money that are not liquid, such as term deposits. As these are not liquid guarantees, in both cases, the borrower isn't deprived of the use of any asset s/he could invest in another income-generating activity. Even if s/he bears the risk of having the assets seized, depending on the contractual conditions, the client still has the use of the physical assets. In the case of term deposits, these were, by definition, not accessible to the client before pledging them to the financial institution.

- 
- ***When deposits can be accessed by the clients for needs other than repaying the loan.*** Under these conditions, deposits still represent a security buffer in the lender's eyes, while at the same time bring a real value-added to the client who is allowed to tap into savings to face emergencies.

In countries with low financial literacy and under-developed use of financial services, savings programs raise awareness about the use of savings accounts. Nonetheless, the impact in terms of financial education and on the APR are effective if, and only if, the client has access to the constituted savings during the loan term. Voluntary savings accounts, which the client can access at any time and are not locked up as loan security, have beneficial impact and are not considered an additional cost to the loan.

Often, financial institutions offer a passive interest rate remunerating compulsory savings or deposits. This is a laudable practice that also contributes to financial education, getting clients used to the fact that they should earn interest on deposits, especially that deposit-taking institutions usually generate income from these deposits. Nevertheless, these passive rates are generally quite low, and considering the spread between active and passive interest rates in microfinance, this practice only marginally contributes to lower the APR, and will never offset the impact of the deposit on the total price of the loan, as the interest earned will never equal the interest they are actually paying on the security deposit.

Section D - Insurance

Insurance responds to the same logic as other fees, and should be included in the APR calculation when they represent a compulsory cost for a borrower in order to access a loan. In some cases, insurance actually brings a significant value added to the client; however, in many cases insurance is designed to protect the institution rather than the borrower. The decision of when to include insurance in the price is best based on whether the insurance is required in order to receive the loan. Any truly voluntary insurance is a separate product that can be purchased or declined by the client and; hence, can be excluded from the APR calculation. If any given insurance product is compulsory to access a loan, then it should be included in the price calculation and the client then knows that the price of “credit and insurance” is x%.

Some insurance can be excluded from the APR

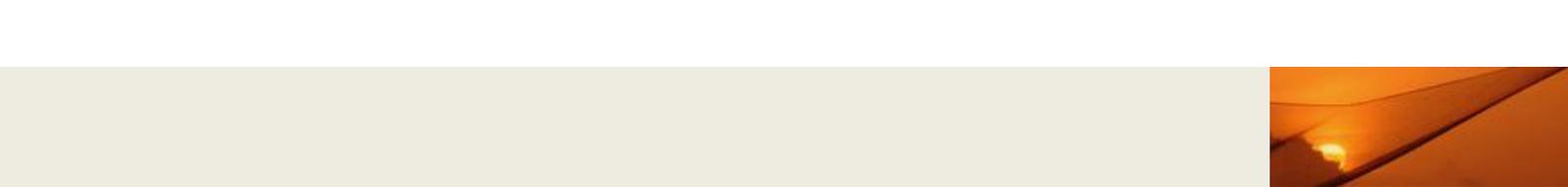
Microfinance institutions have developed over the years the use of some micro-insurance products they offer to clients along with a loan, in their own name or acting as a broker of an insurance company. The purpose of these insurance policies can be diverse, as illustrated in the table below, even though in practice, most micro-insurance is merely credit life insurance to protect the MFI from default in the case of the death of the borrower. When buying insurance is a pre-requisite to receiving the loan, the cost of the insurance should be included in the APR.

This is not the same as when clients are offered optional insurance services. In these cases, clients have the option to buy credit only and it would be fair to state the credit-only APR. In addition, some insurance products can bring additional benefits that are not directly linked to the loan, and bring a real added-value to the client.

Product	Credit life insurance	Credit life insurance with additional benefit	Damages insurance	Health insurance
Description	1. In case of death, the outstanding amount due by the borrower is reimbursed to the MFI by a third party insurer.	1. In case of death, the outstanding amount due by the borrower is cancelled by the MFI / reimbursed to the MFI by a third party insurer 2. Benefit in capital to the chosen beneficiary. Example: funeral insurance, in-kind or paid benefit in order to cover funeral expenses.	1. Goods: coverage against fire, accidents, etc.) 2. Livestock: coverage against disease, feed shortage 3. Agriculture: coverage against disease, climate, price variation.	1. Coverage of health expenses
Direct beneficiary	MFI	MFI / borrower's beneficiary (family)	Borrower	Borrower (and family)
Indirect Beneficiary	Borrower's family / guarantors	-	MFI: reduces the risk for the client to see his income severely affected by external factors.	MFI: contributes to stabilize borrower's expenses

Compulsory insurance: clients need a choice

It is worth noting that in the case of insurance, more than any other non-interest additional cost, it is not enough to include the cost in the APR to ensure proper transparency towards clients. Even **when a financial institution requires its clients to get an insurance against a specific risk, clients shouldn't be forced to take the insurance offered by the institution**. Clients should indeed be given the opportunity to choose an alternative insurance provider that may be able to insure the same risks at a more competitive price. Even if it is true that grouping the credit and insurance sales process provides the institution with greater efficiency gains and lowers its cost, FIs could be tempted to take advantage of their dominant position and charge abusive prices. Clients should always have a choice between the credit provider and competitors.



In addition, and even though it may appear as stating the obvious, ***clients should be clearly informed of the benefits they might get from the insurance products.*** Indeed, benefitting from insurance depends on clients' ability to make a claim for it: their knowledge of the conditions under which they can make the claim, and the procedures to follow. In addition to informing beneficiaries, FIS should also be able to prove that they have undertaken all the necessary measures to find them when the situation arises.

Chapter 3 - Price caps

To begin with, it is essential to recognize that “interest rate caps” are not really “price caps”. Legislation may limit the interest rate charged, but if there is no full-price formula that considers issues such as how interest is calculated, or fees charged, or security deposits required, the true price paid by the client can differ dramatically from the interest rate cap and the legislation does little more than give a false sense of security to borrowers.

In addition, whatever the motivations for imposing price caps or usury laws, they may have, at best, no effect on the real prices paid by borrowers, and in other cases, undesirable side-effects that make things worse than they were before. Whereas *the common assumption is that borrowers are protected from predatory lending thanks to price caps, the real challenge is to actually enforce a price cap.*

It can be argued that *the best option to bring prices down is through introducing well-enforced and supervised pricing transparency legislation*, which allows comparability between the different financial services offered and can help to progressively reduce the use of services that are priced higher than their competitors. This section of the handbook examines the side-effects of imposing a price cap. It then highlights the key risks linked to cap prices, and the fact that the pre-requisites necessary for an effective implementation of price caps are rarely fulfilled in practice.

Theoretical approaches to price caps

The debate on the legitimacy of interest rates, and the willingness to limit profit that can be made out of lending money is influenced by centuries of philosophical, religious, and economic thinking. With small variations, the condemnation of interest rate has been common among most cultures and religions, and only by a small increment has it evolved over the years. The meaning of “usury” itself has progressively evolved from being a synonym of “interest rate”, to a synonym of “abusive” or “predatory lending”.

Several motives have been invoked to justify mistrust towards interest rates, but also several nuances granting some acceptability to the practice under certain conditions. At very different times in history, radical criticisms against interest rates have appealed to very different arguments

- In ancient Greece, Aristotle explained that “The most hated sort of [unnatural money-making], and with the greatest reason, is usury, which makes a gain out of money itself, and not from the use of it. For money was intended to be used in exchange, but not to increase at interest.”
- Between the XI and XIII century, many religious scholars condemned usury as the fact of selling time, whereas as a gift of God to mankind, time shouldn't be considered as a merchandise;
- More recently, a Marxist criticism to interest rates put forward that interest rates exacerbated and increased the inequality between the rich and the poor, as the former could expand its control over the latter, for an amount that exceeds the amount of capital he actually owns.

In parallel, other theorists deemed certain forms of return on money lent acceptable.

- Thomas Aquinas, in his own word, drew our contemporary distinction between a lender and a shareholder, who intends to earn some profit but shares the risk with the money user: “[Different from a lender of money], one who entrusts his money to a merchant or craftsman so as to form a kind of society, does not transfer the ownership of his money to them, for it remains his, so that at his risk the merchant speculates with it, or the craftsman uses it for his craft, and consequently he may lawfully demand as something belonging to him, part of the profits derived from his money.”

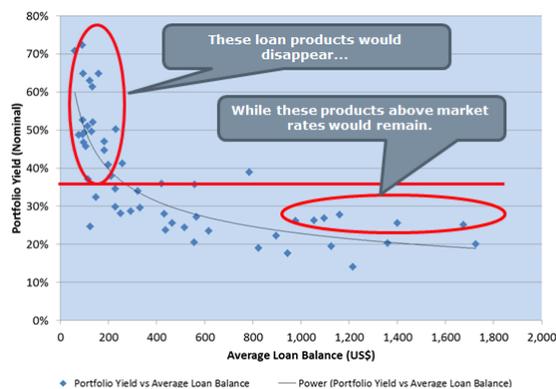


While there are moral, religious, and political motives in favor of interest rate / price limitation, there is actually no purely economic or financial argument that is convincing. In fact, most MFIs try to offer useful credit services to their clients, and their prices fairly reflect the cost of providing services to their particular target clientele. If clients continue to purchase these services, it can be assumed that it is because they represent a good deal to them, not only compared to other options, but because their businesses generate enough return on investment to cover the cost of borrowings (though there are yet no rigorous analytical studies that confirm this). In the meantime, trying to limit prices in order to prevent some abuses would force many lending institutions to either close their doors, or to shift to higher loan amounts which can be sustainably offered under the price cap.

Impact of price caps on product offering

Price caps make smaller loans unsustainable and; thus, reduce the service offering for the lower segments of the population

If a price cap is strictly respected - an assumption that we will discuss later on - it has the inevitable effect to make some products unsustainable; namely, the products that are most costly to offer. Putting aside the hypothesis of predatory lending, the reason behind high prices is usually smaller loan size. Indeed, the cost to file an application and disburse a loan is mostly a fixed cost for a FI. As the loan amount gets smaller, its cost as a percentage of the amount disbursed increases dramatically.



Small loans are usually the loans disbursed to the poorest population, and certainly to the people who have less access to financial services. When setting a price cap, decision makers should be aware that if the cap is too low, the consequence will most likely be to deprive this population from accessing formal financial services. It could even have worse consequences, encouraging FIs to disburse larger loans to the same clients who do not necessarily have the ability to repay, putting clients at risk of over-indebtedness.

Four key elements to ensure that a price cap can be effectively implemented

1: A precise understanding of the microfinance market. There is no easy answer to the question “what should be the maximum price allowed”. In fact, there might be more than one answer per country. For a price cap to be meaningful, it certainly should be set at a level that allows market actors to provide the services in a sustainable way (covering the operating costs, cost of financing, cost of credit risk, and allow for a reasonable margin). Only a thorough market analysis can provide a good evaluation of the appropriateness of the prices applied. This is also usually a moving target as market actors can find solutions to improve their efficiency over time. In countries where microfinance services have only been offered for a limited number of years, the prices might not have settled at a stable level, as MFIs are still maturing their practices and efficiency levels.

2: A precise true-price formula. Defining an interest rate cap that does not encompass all of the potential components of the price or that is not precise enough results in a vague limitation that can easily be bypassed. For example, if the nominal interest rate bears a limitation but “flat” calculation is not forbidden, the same rate can be charged either on a declining basis, or as a “flat” rate, with the effect of almost doubling the APR. Similarly, if interest rates are limited using a formula that is not restricted to the nominal rate, but leaves a few fees out of its scope, these loopholes can be used by financial institutions. Indeed, if charging compulsory fees is not strictly regulated nor taken into account as part of the price of the loan, it can be used as an alternative revenue source by financial institutions in order to maintain high prices while formally complying with the limitation. In some extreme cases, financial institutions can also burden their clients with other services or goods, whose purchase is vividly advertised or even made compulsory to get a loan.

3: An adequate supervision capacity. Whether it is transparency we are aiming at or pricing limitation, a solid supervision is needed. Authorities must be able to perform detailed audits of the financial services providers in order to check their compliance either with the price calculation formulas, and when applicable with the corresponding cap. Depending on the number of institutions, the quality of information available, and the location of branches to be audited, this process might require significant manpower and imply additional regulatory costs.

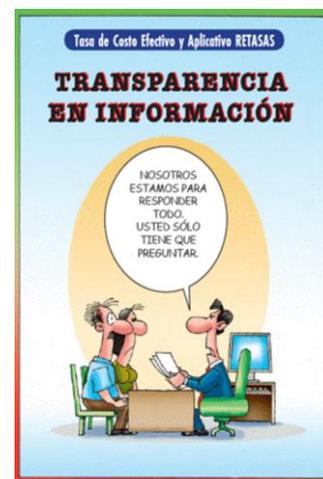
4: Education. Clients should be aware of the way prices should be disclosed to them, in order to be part of the supervisory mechanism, and to be able to report abuses.

In reality, **these four factors have rarely been jointly implemented.** Price caps have often resulted in a *less* transparent market. Well intended market actors have chosen to find ways to go around the legislation to be able to provide their services in a sustainable way. Market actors that might have the objective to maximize the profits derived from loans to vulnerable populations are usually still able to provide their services at a cost that is higher than the usury limit, by using loopholes in the regulation or in the supervision.

Transparency education in Peru

In Peru, the Superintendency of Banking, Insurance Companies and Private pension funds (SBS) and the Ministry of Education collaborate in order to provide secondary school students with basic financial education tools. Since 2007, the SBS has trained over 4,700 teachers, and has a long term target of 100% coverage of secondary school students.

The SBS also releases training material and leaflets on transparency in financial services and rights of consumers of credit.



Chapter 4 - Truth-in-lending

Section A - Communication to clients

After reviewing in the previous chapters the effects of many pricing design options on the true price of a loan, this section of the handbook examines how this same price should be disclosed. In that matter, not only is it important to decide what kind of information should be disclosed, but it is of equal importance to consider how it should be disclosed.

Microfinance institutions frequently deal with clients who do not have a high level of financial literacy - or even not a high level of literacy in general. Sometimes, these clients have never accessed financial services before; thus, have rarely come across formal price proposals, contracts, etc. For this reason, microfinance clients do not only need information to be accessible, but also need this information to be communicated and explained to them.

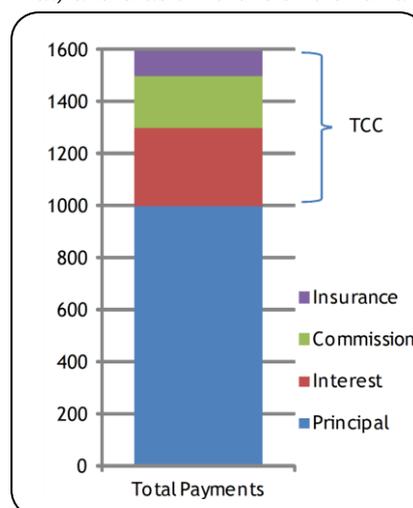
It is both in the client's and the institution's interest that clients understand what their financial obligations are. A better understanding of credit could encourage clients not to take loans that are too large or too expensive for them. This is one of the ways to reduce the risks of over-indebtedness. As a result, this may also be the best way for FIs to reduce their credit risk.

Disclosure content: cost and non-cost information

The right level of disclosure is a subtle balance between too much information vs. not enough. From a radically transparent perspective, an ideal world would be that all MFIs charge a declining balance interest and no additional fees or services. But as we have seen, there are solid arguments justifying that other commissions are charged, and it can even be argued in some cases that they shouldn't be considered as an element of the price of the loan. In order to cope with the diversity of existing pricing architectures, a consensus has emerged regarding the basic disclosure tools that should be used in order to ensure an optimal transparency and comparability of products.

APR disclosure: as a global and synthetic rate, APR remains a crucial feature for transparency. If some charges are to be excluded from the APR, these should be strictly regulated in order to ensure their impact on the price of credit remains minimal, and that different offers remain comparable.

- **Total Cost of Credit (TCC) disclosure:** TCC is the sum of all charges paid, i.e. the difference between total payments from the clients to the financial institution and the principal borrowed. While argued to be easier to understand for clients, TCC can almost never be used to compare different loans that would have different repayment schedules. Indeed, a similar TCC can result in different APRs depending on the repayment frequency or the timing of different commission charges (see box). For this reason, TCC must never be considered a sufficient indication of the true price but must always be communicated alongside APR.



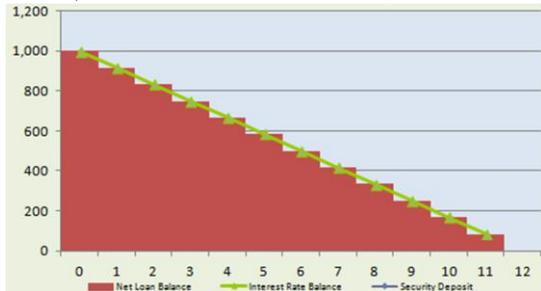
- **Repayment schedules:** complementary to the two previous items, repayment schedules are expected to present the breakdown of each installment per element of pricing: principal repayment, interest, taxes, commissions, insurance, etc. Repayment schedules are complementary to both the APR and the TCC, showing when each cost is paid, and the underlying cash flows used for APR calculation.

Loans with a same TCC can have a different APR

Imagine a 12 month loan of \$1,000. If charged a 2% monthly interest rate on declining balance, repaid monthly, the total amount of interest is \$130. What happens if we charge the same \$130 at disbursement instead of spreading it over the loan term?

Interest charged on a declining balance

When actualizing the sum of interest paid at each installment, the present value of interest is only \$118.7, instead of the nominal \$130.



Nominal rate
2%

APR
24%

TCC
\$130

Average net loan balance

On average, the borrower has had \$542 in his hands, or 54% of the original loan amount.

The same \$130 are charged up-front

This loan bears the same TCC, corresponding to \$130. But as this amount is paid up-front, its present value is \$130, resulting in a higher real price reflected in a higher APR for the client.



Nominal rate
0%

APR
26.52%

TCC
\$130

Average net loan balance

On average, the borrower has had \$412 in hands, or 41% of the original loan amount

When combined, APR, repayment schedules and TCC provide a good level of transparency on the price of a loan. Yet the way this information is communicated to the client is also crucial for real transparency on loan conditions. Disclosure needs are not the same throughout the commercial process. Each step requires its own information, and each piece of information has its importance.

Disclosure before the sale

Clients need to have access to public information regarding the financial services offered, before entering contractually into a commercial relationship with an institution. As this information might determine a client's choice before he sets foot onto the institution's premises, its quality, clarity and transparency is crucial.

Prices can vary from one loan to another, reason for which it is a complex issue to determine what prices should be disclosed. Several options can be considered, with different levels of complexity and precision. A simple option is to define a few standard loans in terms of amounts and duration, and asking each MFI to disclose the APR that would apply for each of these loans.

In addition, **the communication mediums need to be adapted to the target population** in order to be easily accessed. From a regulatory perspective, the kind of public disclosure required needs to maintain a balance between (1) level of transparency and accessibility to clients, (2) compliance cost for FIs, and (3) supervisory cost.

Medium	Accessibility	Implementation cost	Supervision cost
Publicaiton on website	Low - access to internet by low-income households is often limited and clients will not necessarily think about it.	Low	Low
Display in branches	Average - future clients have to enter the institution's premises.	Low	High - requires on-site audits to be performed
Leaflets	High - people can get the documents inside and outside the institution, and keep it to study it.	Average	Average - requires on-site checks
Media release (press, radio)	High - people receive the information out of the institution.	High	Low - institutions are in charge of proving they have performed the publication

The Smart Campaign's Client Protection Principles Certification Transparency Standards

The FI fully discloses cost and non-cost information

The FI fully discloses to the clients all prices, installments, terms and conditions of all financial products, including all charges and fees, associated prices, penalties, linked products, 3rd party fees, and whether those can change over time.

The FI clearly presents to clients the total amount that the client pays for the product, regardless of local regulations (including in the absence of industry-wide requirements).

The FI participates in the MFTransparency project (or similar industry project, if applicable).

The FI follows Annual Percentage Rate (APR) or Effective Interest Rate (EIR) calculation formulae. Loan documentation communicates APR/EIR. Customers need to be able to see and compare APR/EIR in a yearly standardized manner that allows for total cost comparisons.

If credit life and/or compulsory savings are mandatory they are taken into account in the EIR calculation.

The FI scores 100 on the MFTransparency Index.

The FI communicates proactively with clients in a way that clients can easily understand

The FI has effective communication. Staff communicates in such a manner that clients can understand the terms of the contract, their rights and obligations. Staff communicates with techniques that address literacy limitations (e.g., materials available in local languages).

The FI contracts contain simple language and no fine print (figuratively or literally). A clear facts summary page is given if the legally necessary contract is deemed too technical for the clients.

The FI avoids using pricing mechanisms that create confusion on the total costs.

The FI's front line staff is trained to communicate with different groups of clients, from different market segments, and who have different skills and levels of understanding (and even perhaps languages), in a way that will help the clients make informed decisions about purchasing a product.

The FI trains and tests clients on understanding of product terms and prices, rights and obligations.

The FI provides financial education training on clients' rights and responsibilities.

The FI uses a variety of disclosure mechanisms

The FI uses at least two different communication channels for disclosing clear and accurate information about the product: written and verbal (to address literacy limitations).

The FI discloses pricing information in public domain.

The FI discloses general terms in public domain.

The FI leaves adequate time for client review and discloses at multiple times

The FI communicates all information related to the product (terms, conditions, etc.) to clients before signing.

The FI gives clients adequate time to review the terms and conditions of the product, ask questions and receive additional information prior to signing contracts.

The FI staff is available to answer questions.

The FI provides accurate and timely account information

The FI gives clients a hard copy of all documents signed by clients (including, but not limited to the contract) with all terms and conditions. The FI ensures that there are no blank terms in all documents signed by clients (including, but not limited to, contracts) - they must be completely filled out.

[group lending] Each client receives a contract, and/or an individual pass/book or payment book with contact terms and signature (even if the contract is between the group and the financial institution).

The FI regularly gives clients clear and accurate information regarding their accounts (e.g., account statements, receipts, balance inquiries, proof of payment for loans).

The FI provides clients with updated balances on request.

Disclosure during the sale

The sales process requires special attention. At this stage, clients have the opportunity to ask all the questions they might have after consulting the publicly available information, and they get a personalized pricing based on their specific situation and requirements: loan amount, duration, risk profile, available guarantees, etc. But **this is also a critical point in time where clients can be influenced and - deliberately or not - misled** regarding the price of the services they are requesting.

The two main documents to support transparency at this stage are repayment schedules and loan contracts. But the usefulness of both documents heavily relies on the loan officer's ability to address the (financial) literacy issues of clients. Loan officers need to be trained in communication techniques enabling them to explain in a simple and clear way the content of documents that might not be straightforward to everyone.

Repayment schedules are important because they include all the key figures allowing clients to understand and compare the cost. In order to make sure borrowers get the same information from each financial institution, but also that this information is provided in the same format allowing for precise comparison, some countries have enforced the use of standard repayment schedules. In other countries, even if standard documents are not required, the disclosure format is strictly defined (see the example of Bosnia below).

In addition to the cost information, **some aspects of the contractual relationship between a borrower and a financial institution must be clearly disclosed.** Most of them because they are a cost that has not yet materialized but could in the future. The most obvious are the **penalties**, i.e. the additional interest or fees paid on amounts in **arrears**. Others might be the amounts charged for **early loan repayment**, or again the conditions under which the interest rate might change, in the case of loans disbursed with a **variable interest rate**.

Most of these items are formalized in the loan contracts, which precisely define the rights and obligations of the clients. As they might be much longer and complex than repayment schedules, their disclosure requires particular attention.

- In order to address literacy issues, loan officers must be able to read aloud the contract to clients who cannot do so for themselves.
- Contracts should be written in plain language, i.e. clear, explicit and succinct wording. Even for literate clients, the use of technical jargon can be discouraging and misleading.
- Contracts should be available in local languages when needed.
- Clients should receive contracts before disbursement, in order to have time to study it. If they receive it and have to sign it at disbursement, they should be granted a "cool-off" period of several days during which they can withdraw from their commitment without any cost implications.

TRAPS

Transparent Pricing Supervision Handbook

An example of standardized transparent repayment schedules in Bosnia

- ✓ The government authorities have enforced the use of standardized repayment schedules that detail all the payments to and from the borrower

(Bank) / MCO										
(Street)										
(City)										
Tel: _____										
Fax: _____										
REPAYMENT SCHEDULE										
Currency _____										
Loan Amount _____										
Installment _____ KM										
Nominal Interest Rate _____ %										
Period	Date and Maturity	Loan Disbursement	Other Payments	Annuity	Principal Payment	Interest Payment	Other Payments by client	Loan Balance	Deposit (Collateral)	
1	2	3	4	5	6	7	8	9	10	
0										
1										
2										
3										
4										
5										
Total										

The sum of all the items provides a precise net cash flow, which is converted into a **discounted cash flow used for APR and EIR computation** which are also disclosed.

		Annual Percentage Rate in % (APR)	Effective Interest Rate in % (EIR)
Net Cash Flow	Discounted Net Cash Flow	Discounted Loan Payments	Discounted Deposit
12	13	14	15

An example of non-transparent repayment schedules

✖ This repayment schedule only displays the principal, interest, and a 30% “Annual Interest Rate”.

Loan Product: 101563 - AGRICULTURE MICRO...		Loan period in months: 9.00	
[Redacted]		No. of Installments: 3 (Quarterly (every 3 m))	
Disbursement Amount: 700,000		Annual Int. Rate (%): 30.00000%	
Disbursement Date: 07/05/2012		Loan Officer: [Redacted]	
		Grace Period: 0 (Quarterly (every 3 m))	
Loan Fund: Kiva			

Due Date	Trx Type	Principal Due	Interest Due	Total Due	Principal Balance	Interest Balance	Total Balance
07/05/2012	Loan Disbursement	700,000	157,500	857,500	0	0	0
07/08/2012	Repayment Due	233,333	52,500	285,833	466,667	105,000	571,667
07/11/2012	Repayment Due	233,333	52,500	285,833	233,334	52,500	285,834
07/02/2013	Repayment Due	233,334	52,500	285,834	0	0	0

When including all the cost borne by the client, the APR is actually 80.53%

Loan Amt: 700,000.00	Pricing Info		Quoted info	Total Pd	Incr	MPR	APR	EIR
Avg Balance: 466,667	Interest	33.60% annual, Flat	157,500.00	40.98%	3.42%	40.98%	50.62%	
Disb Date: 7-May-12	Fees	2.50% upfront	17,500.00	5.22%	3.85%	46.20%	58.68%	
Term (Months): 9.0	Insurance	30,000 upfront	30,000.00	9.33%	4.63%	55.53%	74.17%	
Grace (Months): 3.1	Taxes	None	0.00	0.00%	4.63%	55.53%	74.17%	
Transp INDEX: 42	Deposit	20.00% upfront		25.00%	6.71%	80.53%	123.54%	
	Total Cost		205,000.00		6.71%	80.53%	123.54%	

Loan Amount & Balance				Total Cost of Loan				Compulsory Deposit				
Per	Date	Disburse	Principle	Balance	Interest	Fees	Insurance	Taxes	Deposit	Interest	Withdraw	Balance
Transparent Price (nominal APR)					40.98%	46.20%	55.53%	55.53%	80.53%			
Totals		700,000	700,000		157,500	17,500.00	30,000.00	0.00	210,000.00	0.00	(210,000.00)	
0	7-May-12	700,000.00	-	700,000.00	-	17,500.00	30,000.00	-	140,000.00	-	-	140,000.00
1	7-Aug-12	-	233,333.00	466,667.00	52,500.00	-	-	-	23,333.30	-	-	163,333.30
2	7-Nov-12	-	233,333.00	233,334.00	52,500.00	-	-	-	23,333.30	-	-	186,666.60
3	7-Feb-13	-	233,334.00	0.00	52,500.00	-	-	-	23,333.40	-	(210,000.00)	-

Non-interest charges include :

- A 33.6% “flat” interest rate
- An up-front fee amounting to 2.5% of the loan amount
- A fixed up-front fee of 30,000
- A 20% compulsory deposit made up-front

Section B - Communication to the market

The previous sections have provided a detailed overview of all the good practices that can and should be implemented in order to guarantee the provision of transparent financial services. Most of the tools mentioned so far are aimed at the empowerment of clients through better information, enabling them to choose the best product for the best price. Nevertheless, we must acknowledge that even with a good disclosure regime in place, microfinance clients usually face several constraints that will hamper the transparency virtuous circle. For example, such constraints may include limited time to search for information and limited options offered to them because of their location or risk profile. As a result, the benefits of transparency are likely to be dampened if driven by clients alone.

For this reason, transparency policies must not only address clients. Even though clients may have stronger impact, on the long run, on the market dynamics, several other market players might have a quicker impact if provided with relevant information.

Information users

MFIs themselves need information on their competitors' prices. The aim of transparency is not to point fingers at some institutions but to give institutions that have been charging prices that are above the market rates the opportunity to align to a fair price. This will represent a challenge, in particular, to those institutions where high prices are not the result of high profits, but instead a result of significant inefficiency in operations. In any case, the information made available at the national level will be one more tool for these institutions to understand their position in the market and adapt their situation.

Investors and donors need information on the prices charged to microfinance clients in order to assess the market position of the institutions they finance or support. For that purpose, they need comparable information on the institutions' pricing and profitability levels, in order to assess their competitiveness.

How the required information can be disclosed to market actors:

Regulators are the first recipients of information, mostly because they act as facilitators of market transparency on behalf of future users. They intervene in several steps of the disclosure process:

- They set the standard for disclosure, which information should be disclosed and how;
- They organize the data collection;
- They make sure the information is accurate;
- They take the appropriate sanctions against non-compliant institutions;
- They release both the raw data and useful consolidated information and analysis.

Regulators are often the only players with the legal authority to impose such requirements and enforce them. For them to take a firm stake in the importance of transparency is then crucial, and can be in itself a strong moral incentive for financial institutions to charge fair prices.

✓ Advanced transparency mechanisms in Peru

The Superintendency of Banks and Insurance Companies (SBS) in Peru has put in place advanced pricing disclosure mechanisms. La Tasa de Costo Efectivo Anual (TCEA) is disclosed for each credit provider. This regulatory interest rate formula is compounded (similar to EIR), even though it only takes into account the monthly payments and does not include non-recurrent charges such as disbursement fees. For each institution, a wide array of standard TCEA are disclosed and can be sorted according to several criteria:

- Per region;
- Per type of product : fixed asset, working capital, vehicle, consumer loan, credit card , revolving loans;
- Per loan size: for each loan category, the loan term is fixed and corresponds to the most standard case in Peru (24 months for fixed assets, 9 months for working capital, etc.) but several typical loan size are available for each loan;
- Per currency: TCEAs are available for loans in national currency or in US dollars.

1. Seleccione la Región

LIMA

2. Seleccione el Tipo de Operación

CREDITOS

3. Seleccione el Producto

CAPITAL DE TRABAJO

4. Seleccione las Condiciones

PRESTAMO CAPITAL DE TRABAJO POR S/. 10 000 A 9 MESES

PRESTAMO CAPITAL DE TRABAJO POR S/. 1 000 A 9 MESES

PRESTAMO CAPITAL DE TRABAJO POR S/. 10 000 A 9 MESES

PRESTAMO CAPITAL DE TRABAJO POR US\$ 500 A 9 MESES

PRESTAMO CAPITAL DE TRABAJO POR US\$ 3 000 A 9 MESES

Entidad	TCEA(*)	Cuota
CMAC TACNA	33.75 %	1251.79
EDPYME MARCIMEX S.A.	34.49 %	1254.57
SCOTIABANK PERU	36.19 %	1263.08
CMAC SULLANA	36.45 %	1261.92
CMAC AREQUIPA	37.67 %	1266.45
BANCO DE COMERCIO	39 %	1274.29
BANBIF	42.44 %	1288.18
CMAC PISCO	42.66 %	1284.65
CMAC CUSCO S A	43.95 %	1291.43
CRAC CHAVIN	44.22 %	1286.19
CREDISCOTIA	44.4 %	1294.20
FINAN. PROEMPRESA	44.71 %	1294.60
CMAC HUANCAYO	44.83 %	1294.73
CMCP LIMA	45.11 %	1293.40
FINANCIERA CONFIANZA	46.78 %	1301.33
EDPYME SOLIDARIDAD	48.33 %	1304.28
EDPYME CREDIJET	48.41 %	1307.44
FINANCIERA UNIVERSAL	49.49 %	1308.85
CRAC PRYMER	50.86 %	1316.77
CMAC DEL SANTA	51.63 %	1317.85
CMAC PIURA	51.99 %	1317.55
EDPYME RAIZ	52.25 %	1320.88
EDPYME ALTERNATIVA	53.55 %	1325.15

In addition to pricing disclosure, the Peruvian SBS also discloses on a monthly basis detailed consolidated financial information on FIs, including:

- Solvency and liquidity ratios
- Asset quality information
- Efficiency ratios
- Profitability ratios

	Alternativa	Acceso Crediticio	Credivisión	Nueva Visión	Marcimex
SOLVENCIA					
Ratio de Capital Global (al 31/03/2013)	21.32	18.80	21.89	18.02	19.62
Pasivo Total / Capital Social y Reservas (N° de veces)	3.76	6.72	2.20	5.12	1.58
CALIDAD DE ACTIVOS *					
Créditos Atrasados / Créditos Directos (%)	3.56	5.48	4.83	7.35	7.43
Créditos Atrasados M.N. / Créditos Directos M.N. (%)	3.41	5.48	4.79	7.97	7.43
Créditos Atrasados M.E. / Créditos Directos M.E. (%)	6.68	-	19.50	1.81	-
Provisiones / Créditos Atrasados (%)	158.70	208.52	122.77	122.98	149.62
Cartera de Alto Riesgo / Créditos Directos (%)	3.99	5.80	5.45	8.14	7.43
Cartera Pesada / Créditos Directos y Contingentes (%)	4.75	7.98	6.00	12.12	17.33
EFICIENCIA Y GESTION					
Gastos de Administración Anualizados / Créditos Directos e Indirectos Promedio (%)	22.21	35.51	35.21	13.18	57.53
Gastos de Operación Anualizados / Margen Financiero Total Anualizado(%)	89.17	67.96	114.71	68.40	141.02
Ingresos Financieros Anualizados / Activo Productivo Promedio (%)	33.72	93.00	38.02	28.54	49.97
Créditos Directos / Empleados (Miles S/.)	408	230	191	604	82
Créditos Directos / Número de Oficinas (Miles S/.)	5 245	64 523	2 374	6 404	562
RENTABILIDAD					
Utilidad Neta Anualizada sobre Patrimonio Promedio (%)	5.53	59.79	(22.58)	3.92	(25.22)
Utilidad Neta Anualizada sobre Activo Promedio (%)	1.17	9.58	(6.13)	0.65	(4.74)
LIQUIDEZ					
Adeudos / Pasivo Total (%)	93.87	81.14	92.22	97.13	89.92
Disponibles / Activo Total (%)	8.07	3.29	6.12	8.99	4.16
POSICIÓN EN MONEDA EXTRANJERA					
Posición Global en M.E. / Patrimonio Efectivo (%) **	(0.79)	(1.84)	7.09	2.17	2.25

Section C - Alternative transparency tools

Over the years, microfinance practitioners have created their own tools and self-regulation mechanisms in order to improve transparency, market competition and client protection. None of these tools were intended to substitute efficient national regulation, but all of them can be useful complementary tools for transparency.

The MIX Market (Microfinance Information Exchange)

Since 2002, the MIX provides financial and social performance data and analysis of over 2,000 microfinance institutions around the world. Institutions are given the opportunity to voluntarily report their financial statements on a yearly or quarterly basis, allowing all stakeholders to better understand each MFI's performance and business model, a necessary step when trying to assess the fairness of prices charged.

<http://www.mixmarket.org>

MFTransparency

MFTransparency presents information on credit products and their prices in a clear and consistent fashion, so that all microfinance stakeholders can work with a full understanding of the true prices paid by clients. Additionally, MFTransparency promotes the use of Annual Percentage Rate (APR) and Effective Interest Rate (EIR) as standards for communicating pricing that allow comparison between products. Since 2008, MFTransparency has collected pricing information voluntarily from over 500 voluntary microfinance institutions in over 30 countries. Taking into account all costs borne by clients, MFTransparency has calculated transparent APRs, giving a precise vision of the product and price offering in all the countries where MFTransparency's Transparent Pricing Initiative was performed.

<http://www.mftransparency.org>

The Smart Campaign and Client Protection Principles certification

The Smart Campaign is a global effort to unite microfinance leaders around a common goal: to keep clients as the driving force of the industry. To help the microfinance industry achieve this goal and its double bottom line objective, The Smart Campaign is working with microfinance leaders from around the world to provide microfinance institutions with the tools and resources they need to deliver transparent, respectful, and prudent financial services to all clients.

The Smart Campaign has defined 7 Client Protection Principles that include "Transparency" and "Responsible Pricing". Client Protection Principles have become a standard for most microfinance practitioners, and since 2013, financial institution's compliance with CPPs can be evaluated undertaking a CPP Certification.

<http://www.smartcampaign.org>

Microfinance ratings

15 years ago, specialized microfinance rating agencies (SMRAs) were created with the same purpose of improving microfinance institutions' transparency, encouraging them to open their doors to external evaluators. Over the last decade, SMRAs have assisted the microfinance sector's maturation process, helping institutions to improve, and spreading the best practices across institutions and countries. In more recent years, rating agencies have granted an increasing importance to client protection issues among which one is "Transparency". SMRAs are licensed certifiers of the Smart Campaign's CPP certification.

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More briefings notes, transparent pricing tools and country data are available for free on MFTtransparency's website: <http://www.mftransparency.org>



Agence Française de Développement (AFD)

The Agence Française de Développement (AFD) is a public development finance institution that has been working to fight poverty and foster economic growth in developing countries and the French Overseas Provinces for seventy years. It executes the policy defined by the French Government.

AFD is present on four continents where it has an international network of seventy agencies and representation offices, including nine in the French Overseas Provinces and one in Brussels. It finances and supports projects that improve people's living conditions, promote economic growth and protect the planet, such as schooling for children, maternal health, support for farmers and small businesses, water supply, tropical forest preservation, and the fight against climate change.

In 2012, AFD approved €7 billion to finance activities in developing countries and the France's overseas provinces. The funds will help get 10 million children into primary school and 3 million into secondary school; they will also improve drinking water supply for 1.79 million people. Energy efficiency projects financed by AFD in 2012 will save nearly 3.6 million tons of carbon dioxide emissions annually.

www.afd.fr/lang/en/home



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