

Why We Need Transparent Pricing in Microfinance

Chuck Waterfield

MicroFinance Transparency

28 July 2008

Presentation at Asia/Pacific Regional Microcredit Summit



The Good News in October 2006

BusinessWeek

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DECEMBER 26, 2005

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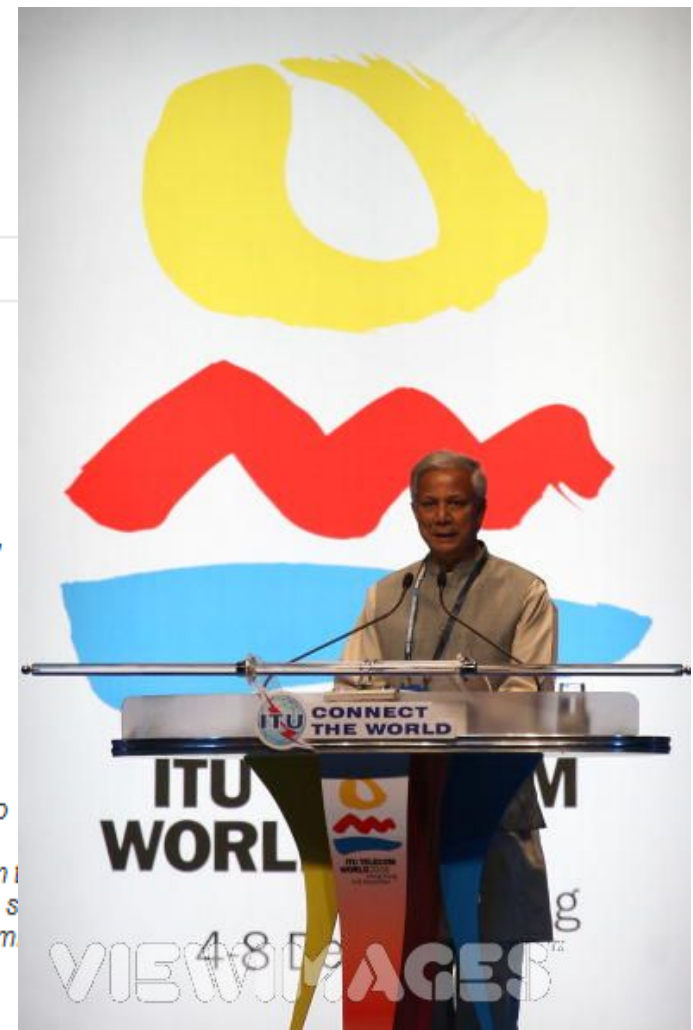
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Nobel Winner Yunus: Microcredit Missionary

**Economics professor Muhammad Yunus
wasn't afraid to turn the rules of banking
upside down**

Editor's Note: Bangladesh's Muhammad Yunus and the bank he founded, Grameen Bank, which created a new category of banking by granting millions of small loans to poor people with no collateral—helping to establish the microcredit movement across the developing world—won the Nobel Peace Prize on Friday. On its Web site, the Norwegian Nobel Committee says Yunus, 65, and the bank "for their efforts to create economic development and peace in the world."



... and the bad press a year later

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Magazine



BRUCE GILLEN/MAGNUM

TOP STORIES

The Ugly Side of Microlending

How big Mexican banks profit as many poor borrowers get trapped in a maze of debt

- The Dark Side of Microfinance
- Plus: Wal-Mart Banks on the 'Unbanked'
- Plus: Compartamos: From Nonprofit to Profit

Google and the Wisdom of Clouds

A lofty new strategy aims to put incredible

Interest rates quoted in Business Week

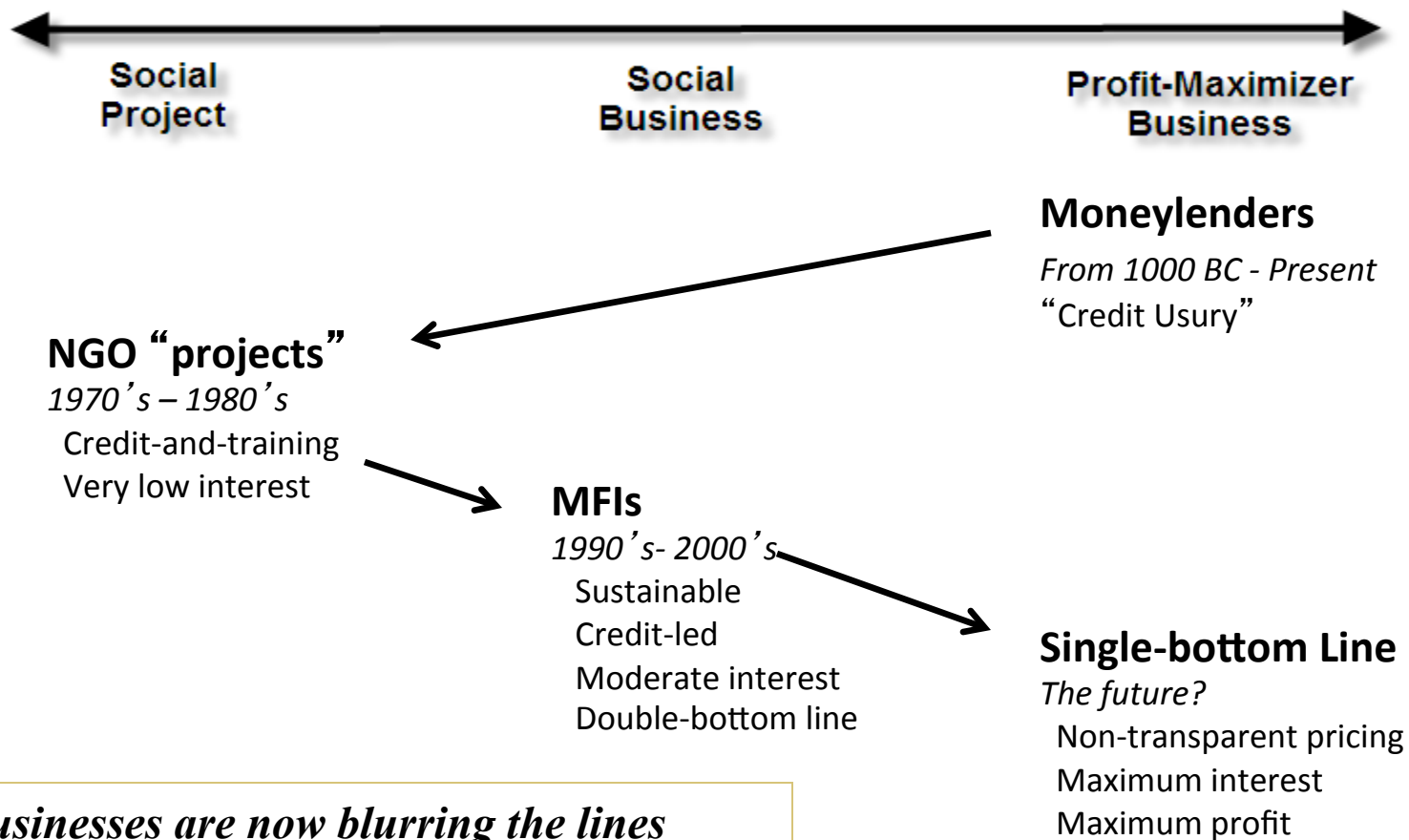
- Compartamos: 105%
- Banco Azteca: 90%
- Wal-Mart: 86%
- Question: *Which of these do you consider MFIs?*
 - Does the **public** distinguish them?
 - Does the **government** distinguish them?
 - Do **clients** distinguish them?
 - Even Business Week really didn't distinguish them

Transparency and Commercialization

- For a decade we have been “moving microfinance into the marketplace”
- We have an impressive record of transparency on financial performance
- However, product pricing is a major element of profit, and transparent pricing has not been widely practiced
- Non-transparent pricing creates a major market imperfection, one that can be used to advantage by new entrants into the market

Financial Services for the Poor

3000 years on one slide



*Some businesses are now blurring the lines
between microfinance and money lending*

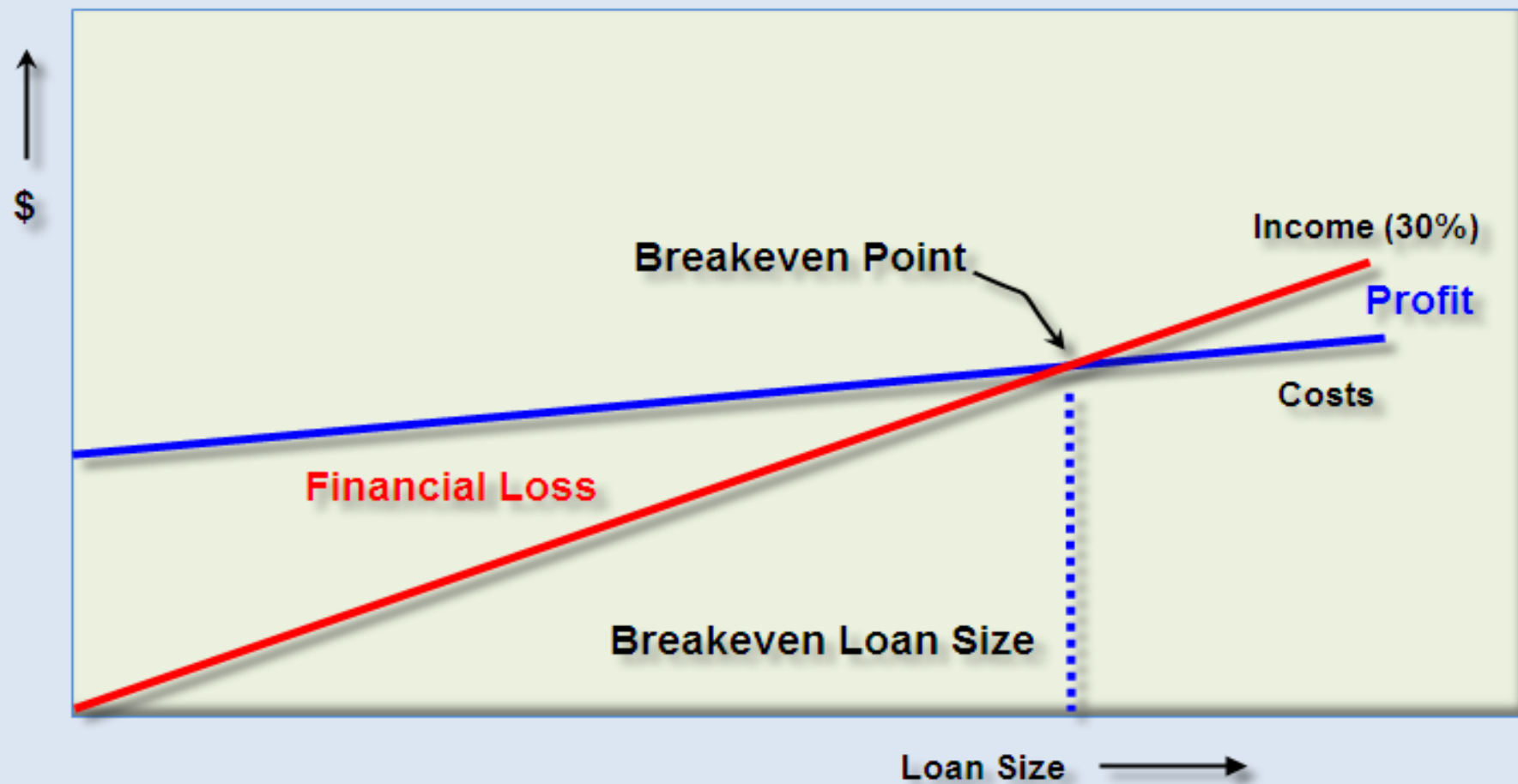
The Need For Pricing Transparency

1. Interest rates vary significantly relative to loan size
2. We operate in an industry where non-transparent pricing is common
3. Non-transparent pricing creates a serious market imperfection, generating the potential for high profits from lending to the poor
4. Pricing transparency is essential to well-functioning markets, promoting efficiency, healthy competition, and better prices for millions of poor people

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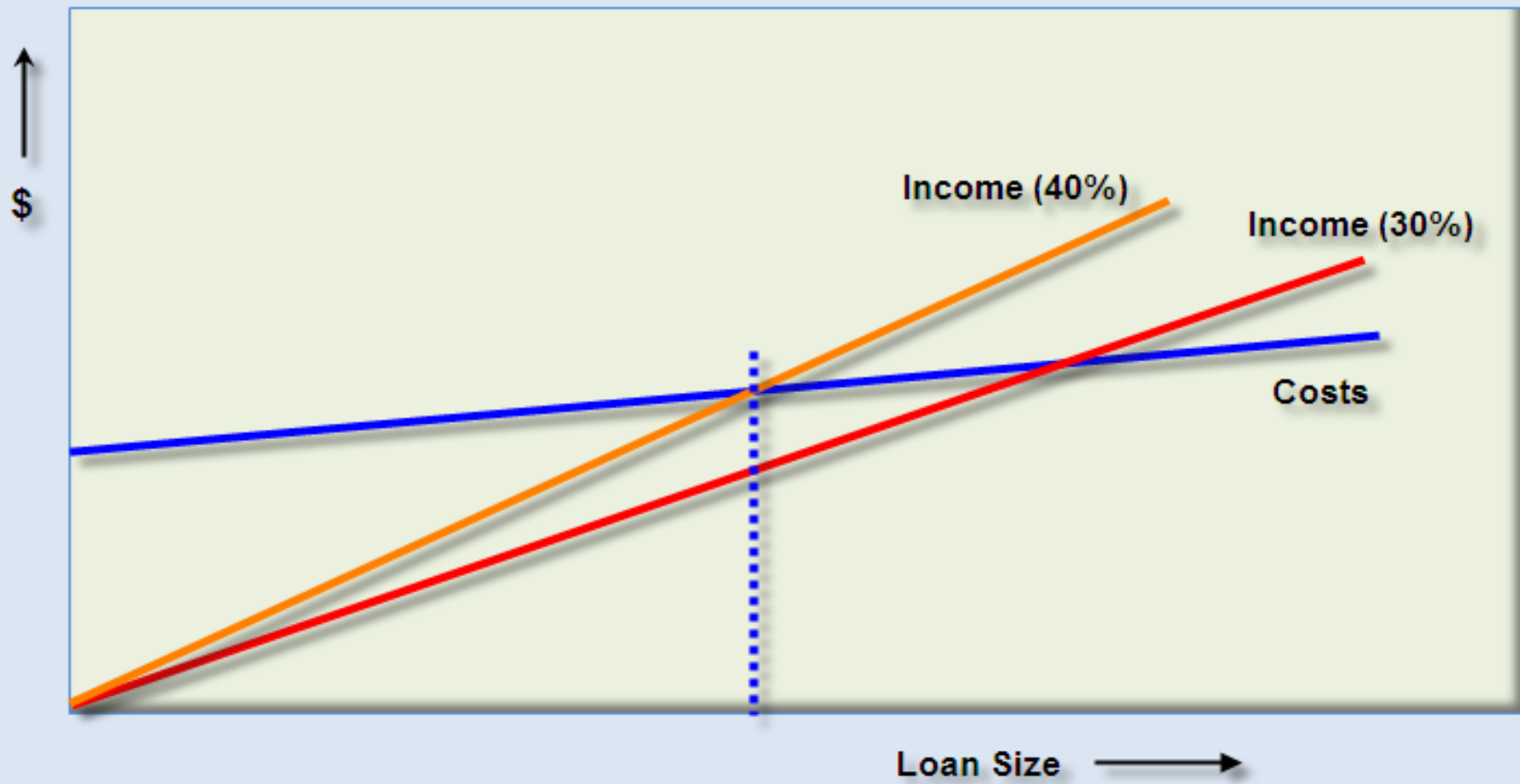
Breakeven Points related to Loan Size and Interest Rate



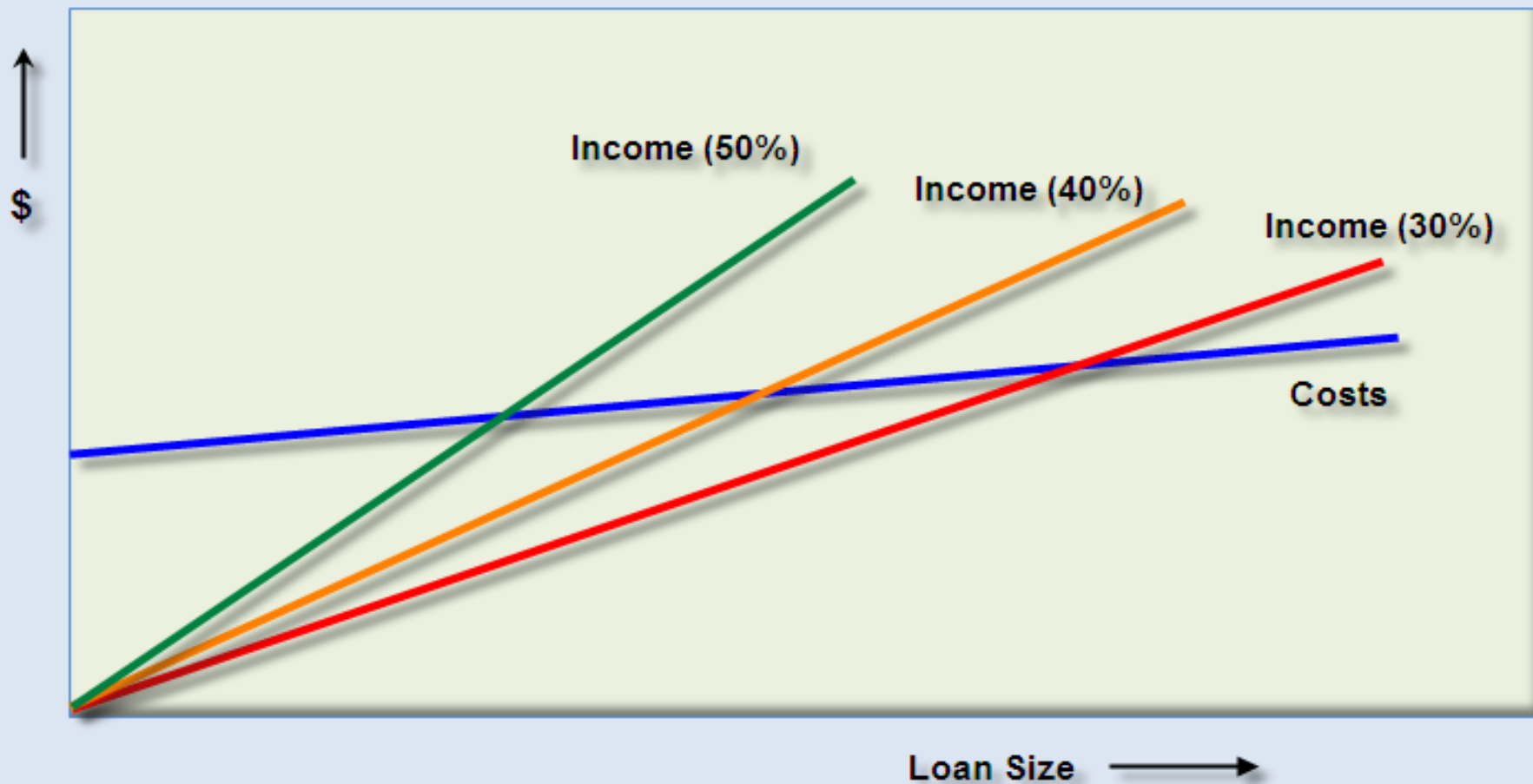
Breakeven Points related to Loan Size and Interest Rate



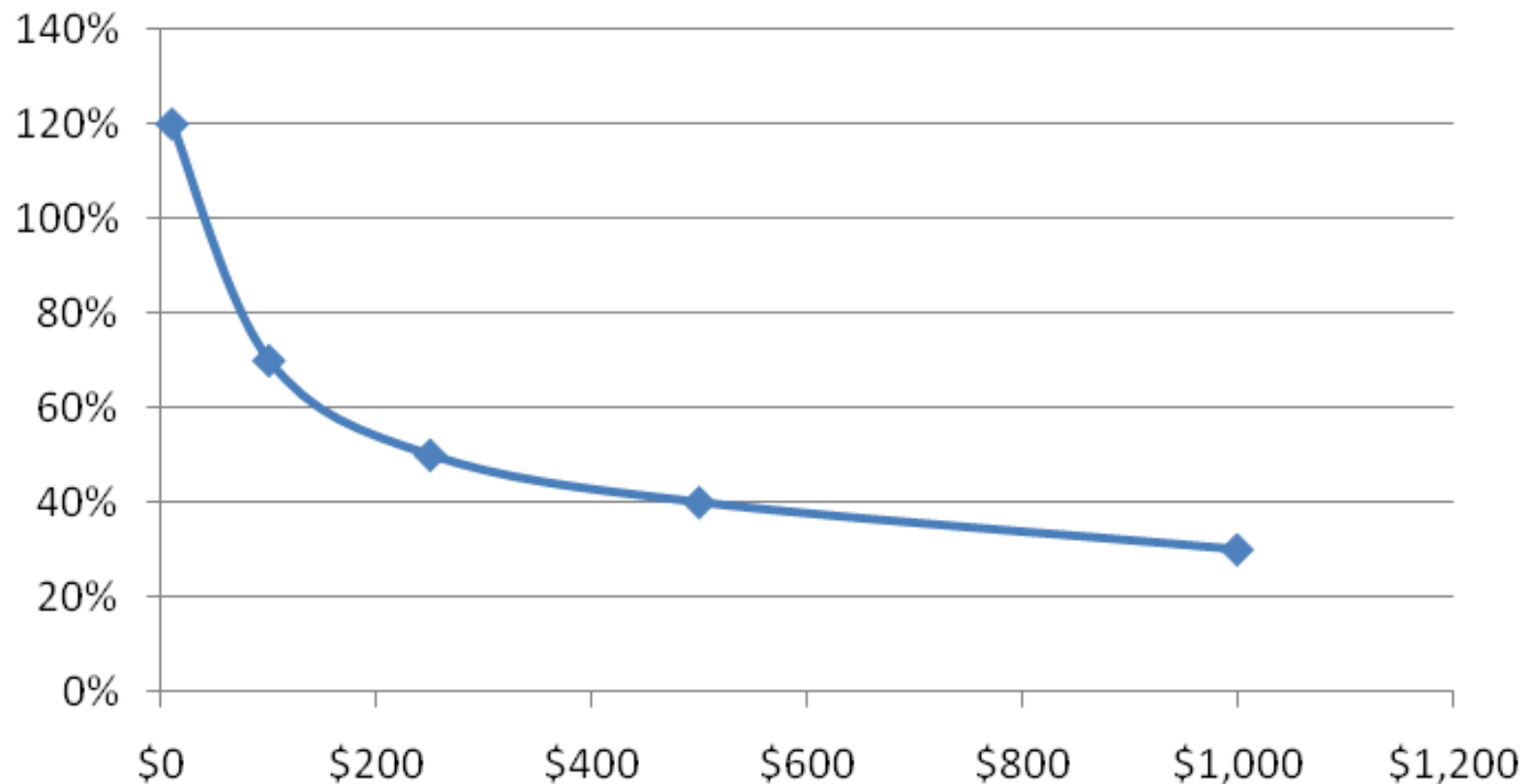
Breakeven Points related to Loan Size and Interest Rate



Breakeven Points related to Loan Size and Interest Rate



Interest Rate and Loan Size



Higher costs for smaller loan amounts require significantly higher interest rates for sustainability

Microcredit is expensive to deliver!

The relationship of costs and income

- **Costs are relative fixed:**

Our staffing and administrative costs are nearly the same for a \$100 loan as for a \$1000 loan...

- **But income (i.e., interest) is expressed as a percentage of the loan balance:**

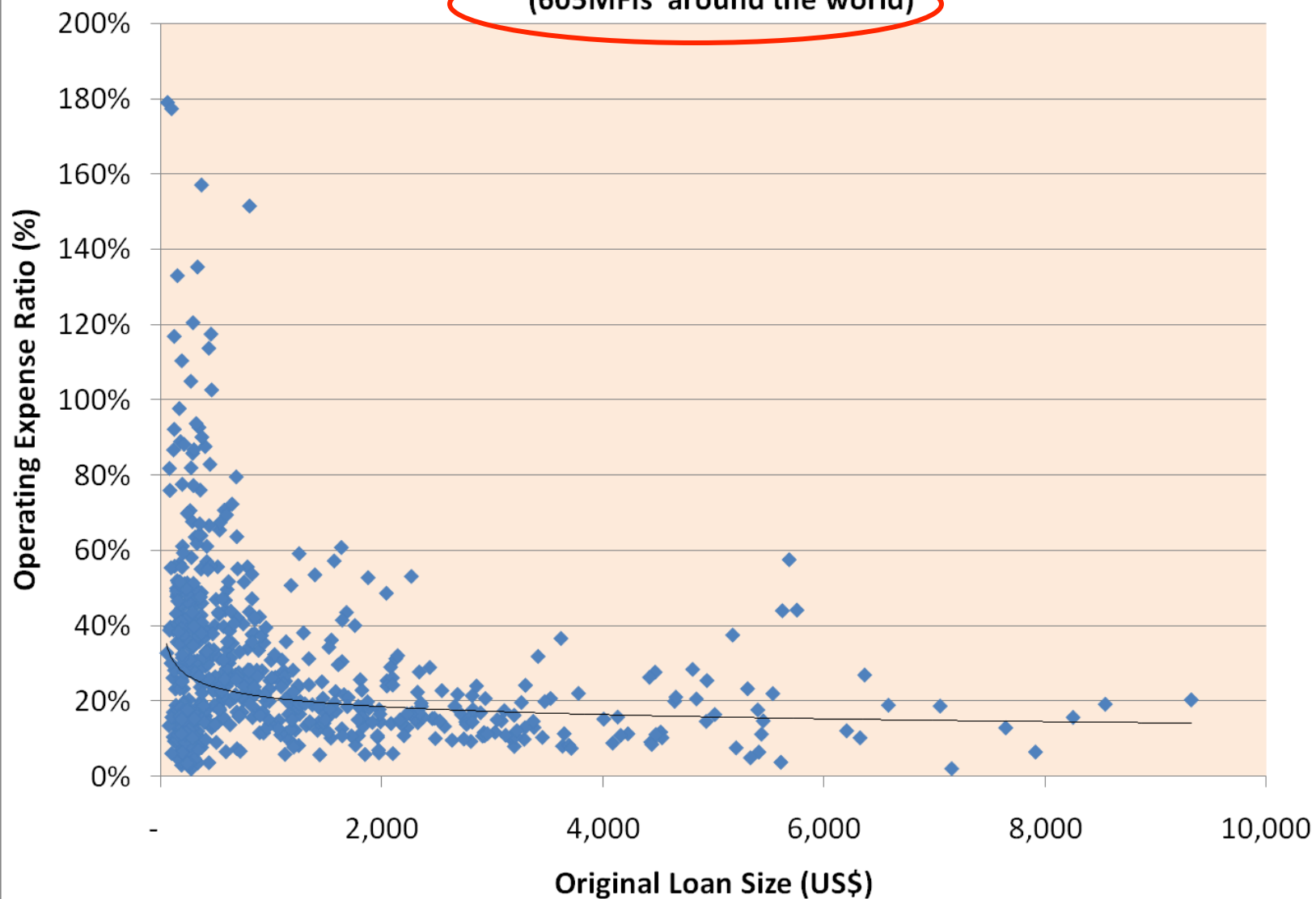
Therefore the interest rate on a \$100 must be much higher than the interest rate on a \$1000 loan

- **Reality: For financial viability, smaller loans must be priced higher, even considerably higher**

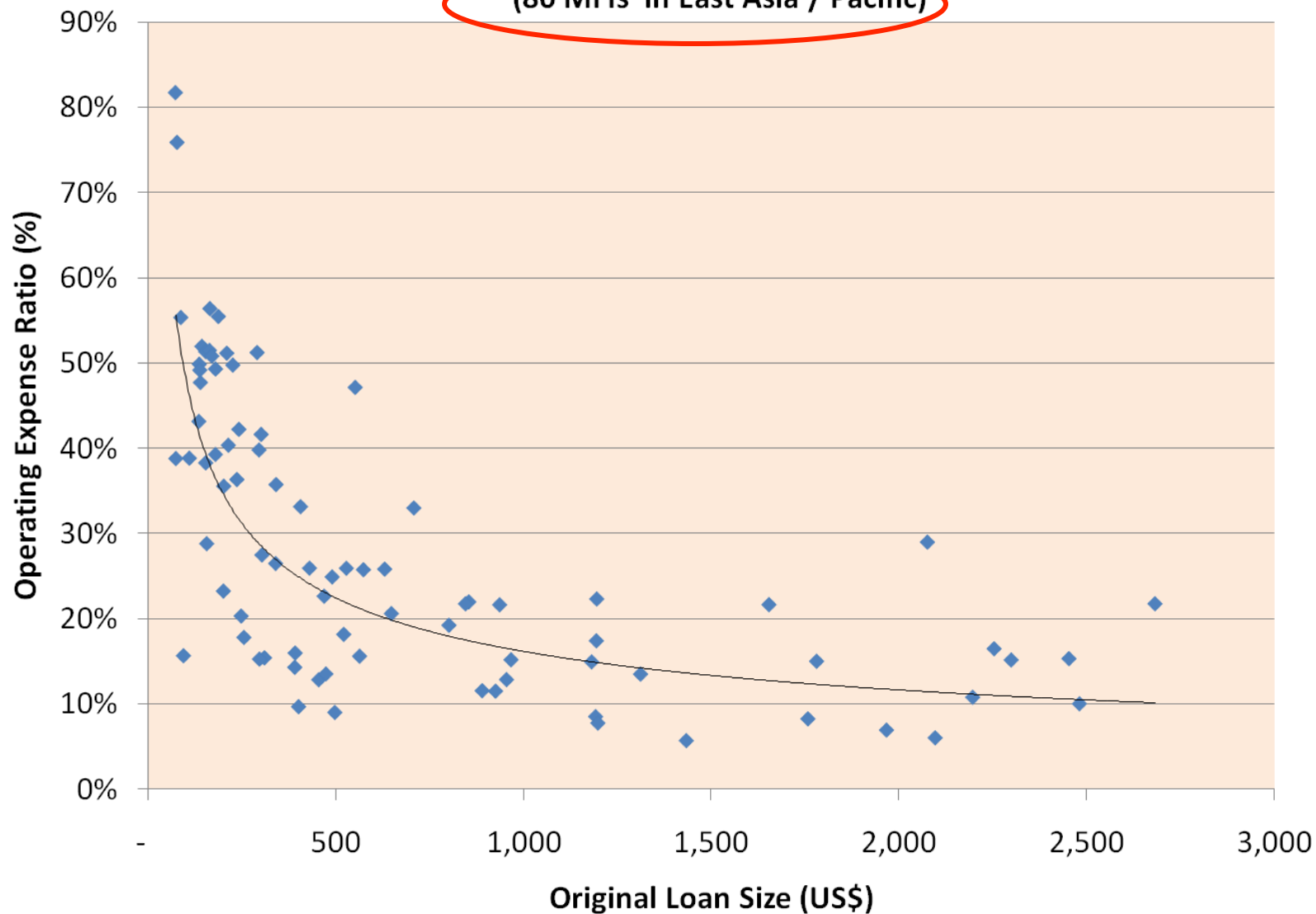
Comparing “theory” with actual data

- The following graphs analyze data from over 600 MFIs around the world
 - All data comes from The MIX
 - The first set of graphs display **operating cost ratios** relative to loan size
 - Later graphs then show the **yield on portfolio** relative to loan size

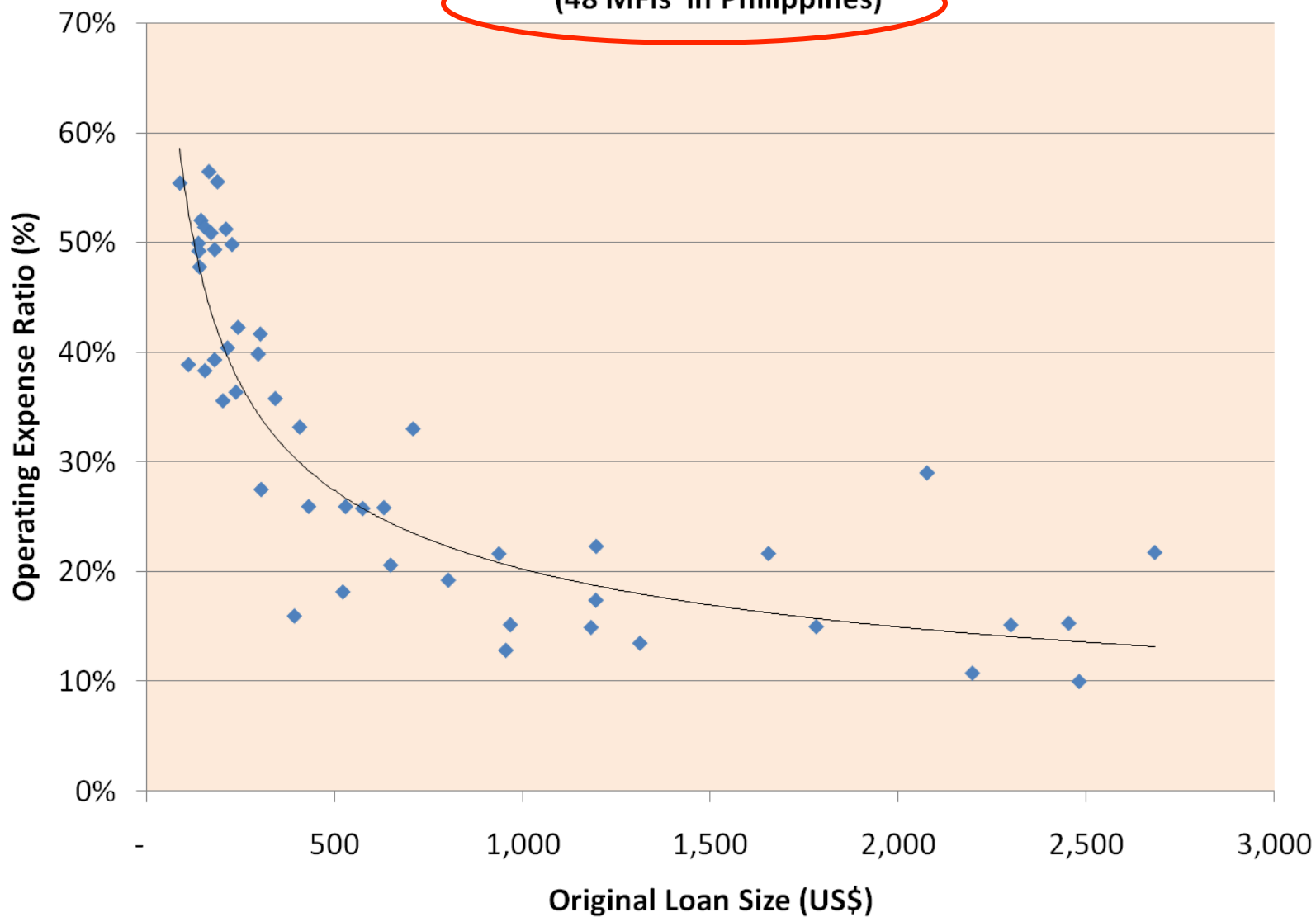
Loan Size and Op Exp/Port % (605MFIs around the world)



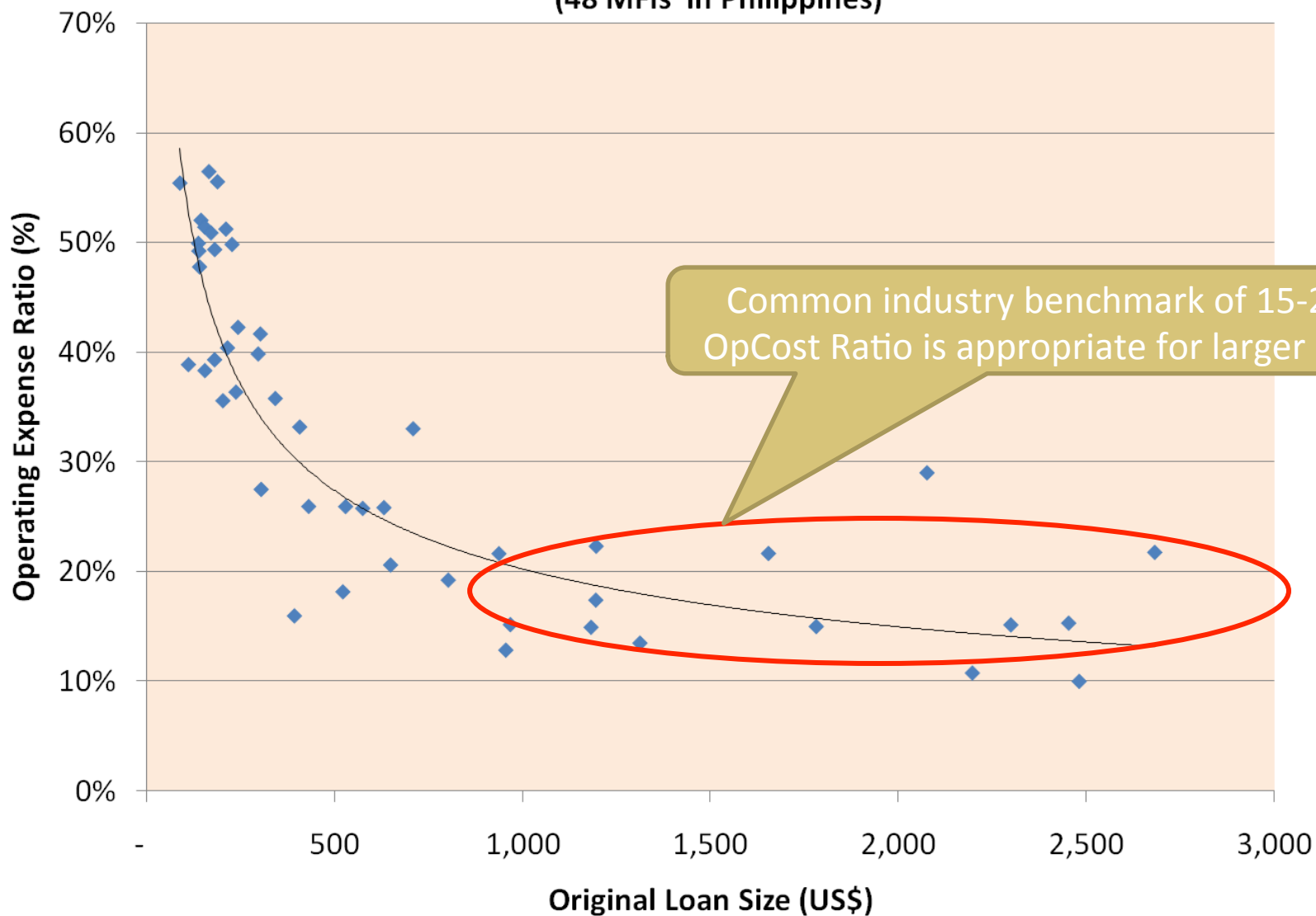
Loan Size and Op Exp/Port % (80 MFIs in East Asia / Pacific)



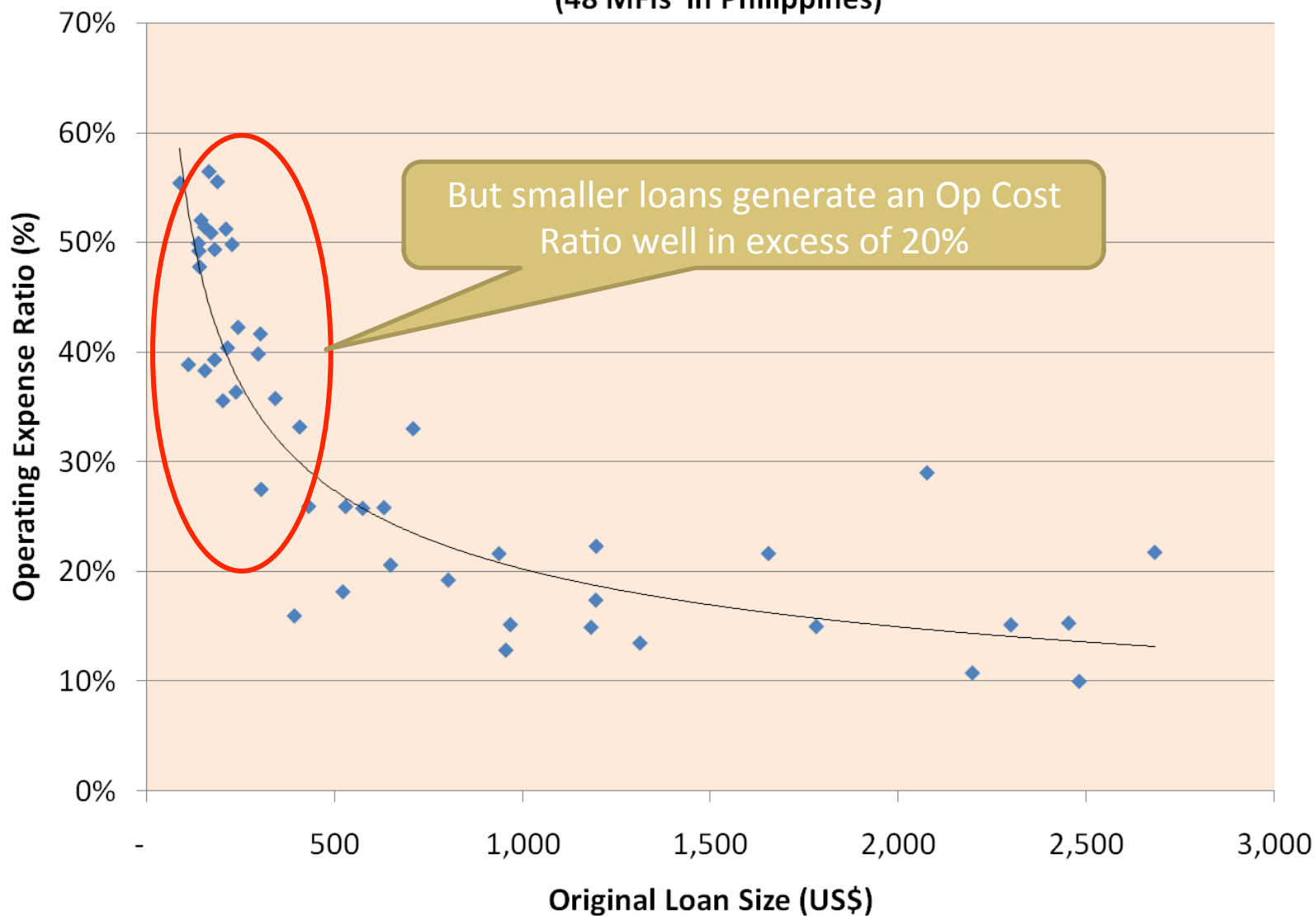
Loan Size and Op Exp/Port %
(48 MFIs in Philippines)



Loan Size and Op Exp/Port % (48 MFIs in Philippines)



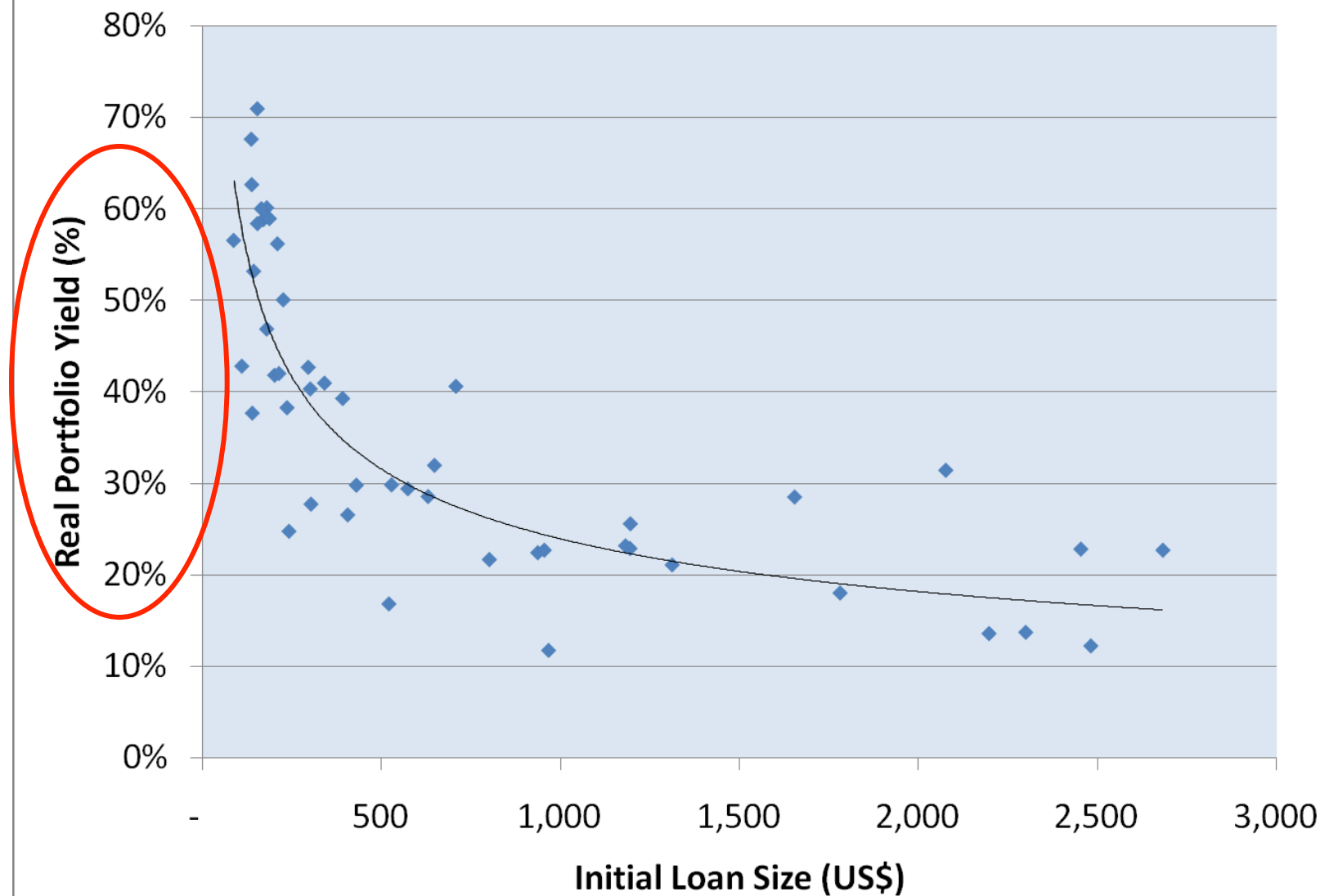
Loan Size and Op Exp/Port % (48 MFIs in Philippines)



Pricing for Different Products

Component	\$100 Loan	\$1000 Loan
Financial Costs	10%	10%
Loan Loss	2%	2%
Operating Costs	50%	15%
Profit	10%	10%
Total Price	72%	37%

Loan Size and Real Portfolio Yield (48 MFIs in Philippines)



The Need For Pricing Transparency

1. Interest rates vary significantly relative to loan size
- 2. We operate in an industry where non-transparent pricing is common**
3. Non-transparent pricing creates a serious market imperfection, generating potential for high profits by lending to the poor
4. Pricing transparency is essential to well-functioning markets, promoting efficiency, healthy competition, and better prices for millions of poor people

How pricing is communicated in microfinance

- Aren't those yield figures in the graphs we just viewed much higher than the interest rates advertised in microfinance?
 - Most of the industry does not practice transparent pricing
- Without transparent pricing, how can consumers understand and compare the price of what they are buying?
 - Let's study how product pricing works

Which loan looks less expensive?

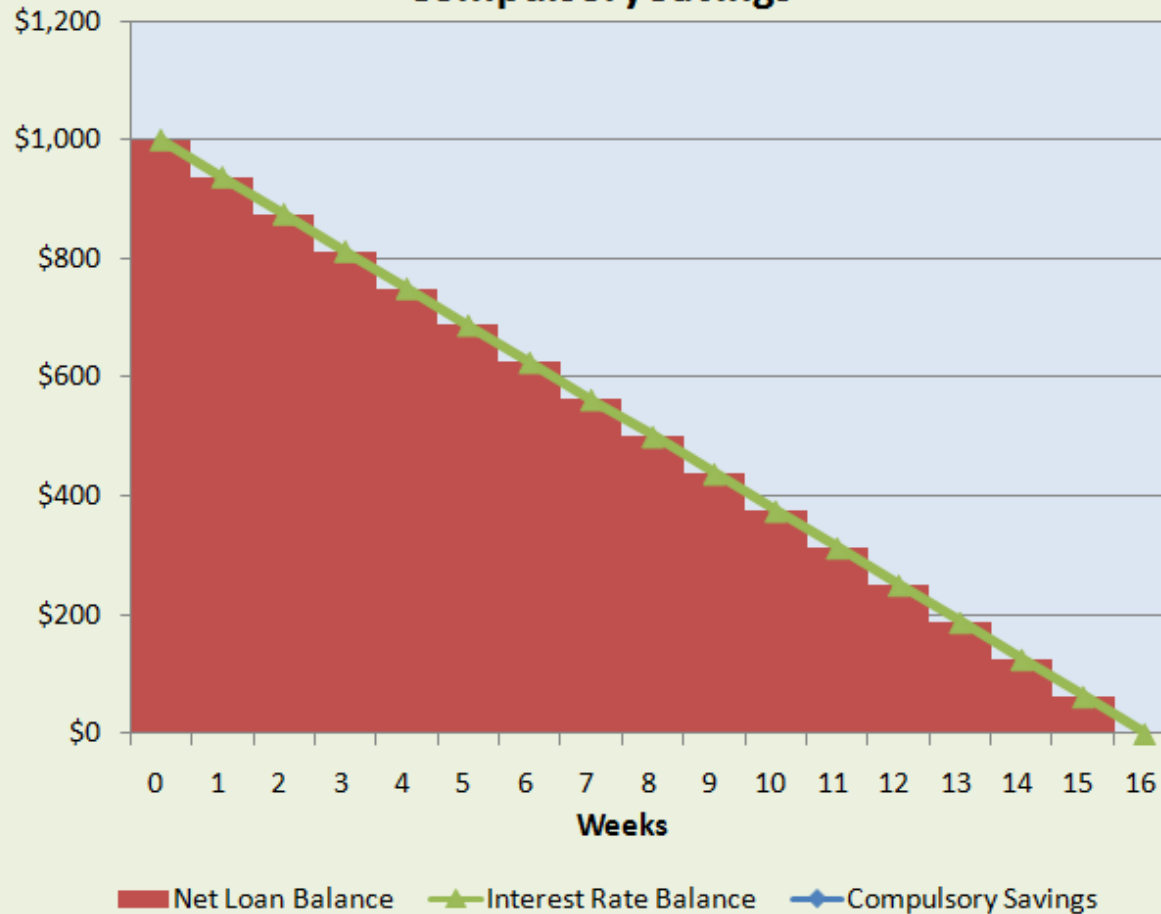
Loan Product	Loan Amount	Total Cost	Length of Loan
Loan Option A	\$1,000	\$131	16 weeks
Loan Option B	\$511	\$425	12 months
Loan Option C	\$360	\$425	12 months

The standard way to compare cost of loan options is by calculating the APR (Annual Percentage Rate).

We will now see how to calculate APRs.

Calculation of APR based on Loan Conditions and Pricing

Relation of Net Loan, Interest Method, and Compulsory Savings



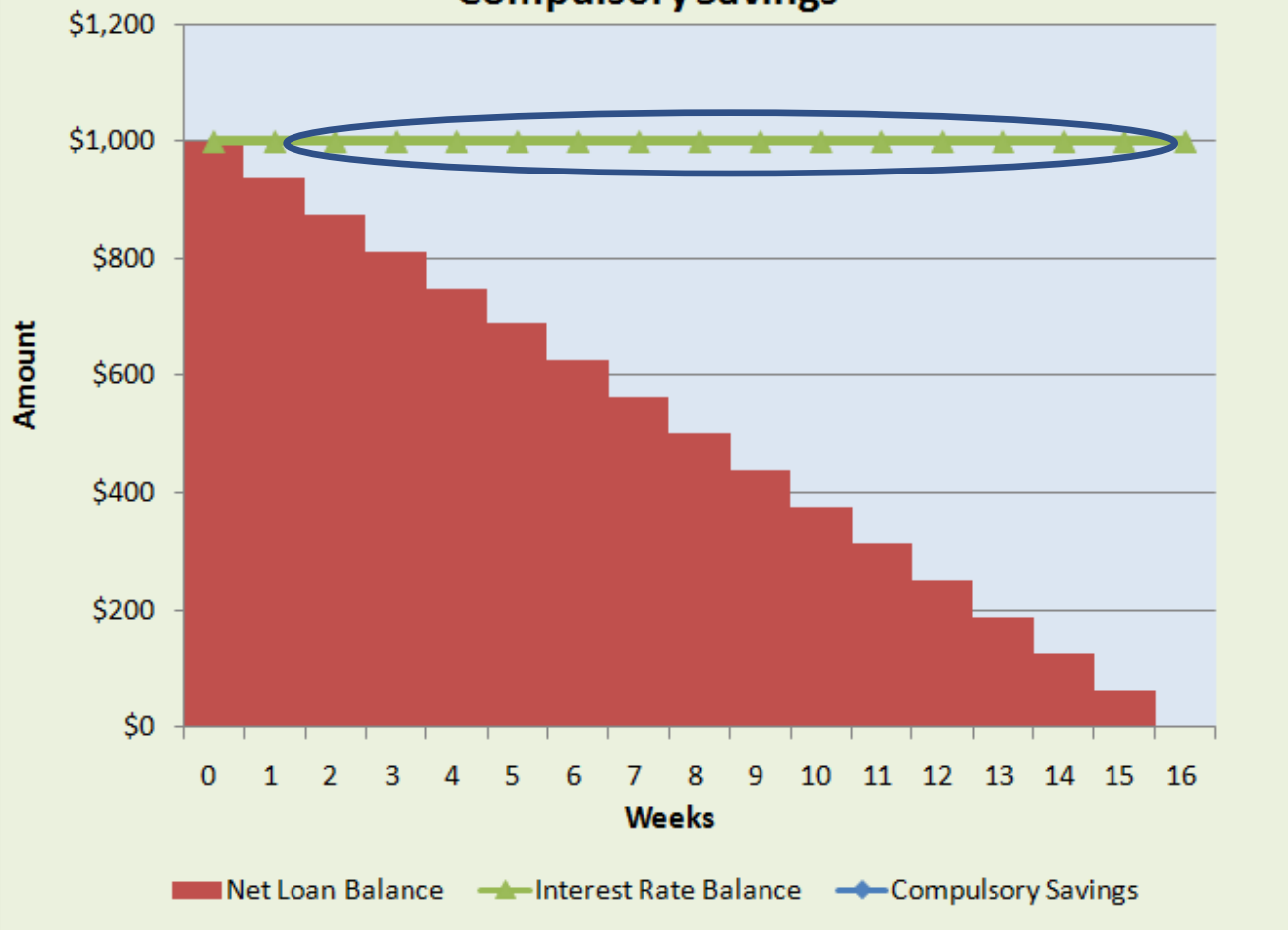
Ann. Interest
Int. Method
Up-Front Fee
Savings
Savings Int.

Nominal	APR
36.0%	36.0%
Balance	
	36.0%
	36.0%

Declining Balance interest reflects the textbook definition of interest as a charge for the use of money over time. APR is equivalent to declining balance interest with no

Calculation of APR based on Loan Conditions and Pricing

Relation of Net Loan, Interest Method, and Compulsory Savings

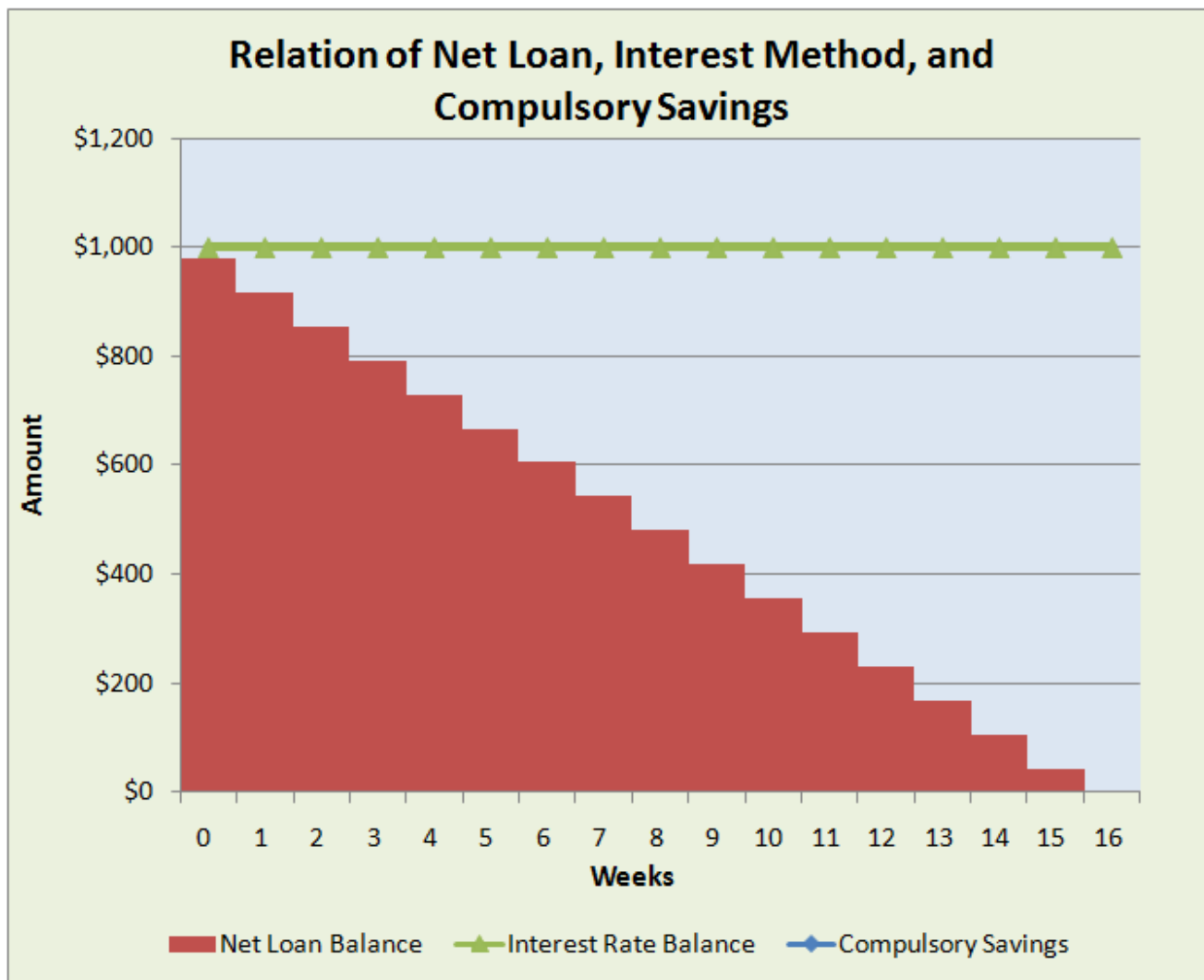


Ann. Interest
Int. Method
Up-Front Fee
Savings
Savings Int.

Nominal	APR
36.0%	65.7%
Flat	
	65.7%
	65.7%

With “Flat” interest, interest is charged on the *original* loan amount resulting in nearly double the cost of declining balance interest. Why double? The area of the rectangle under the green line is almost double the area under the red stair-step loan balance.

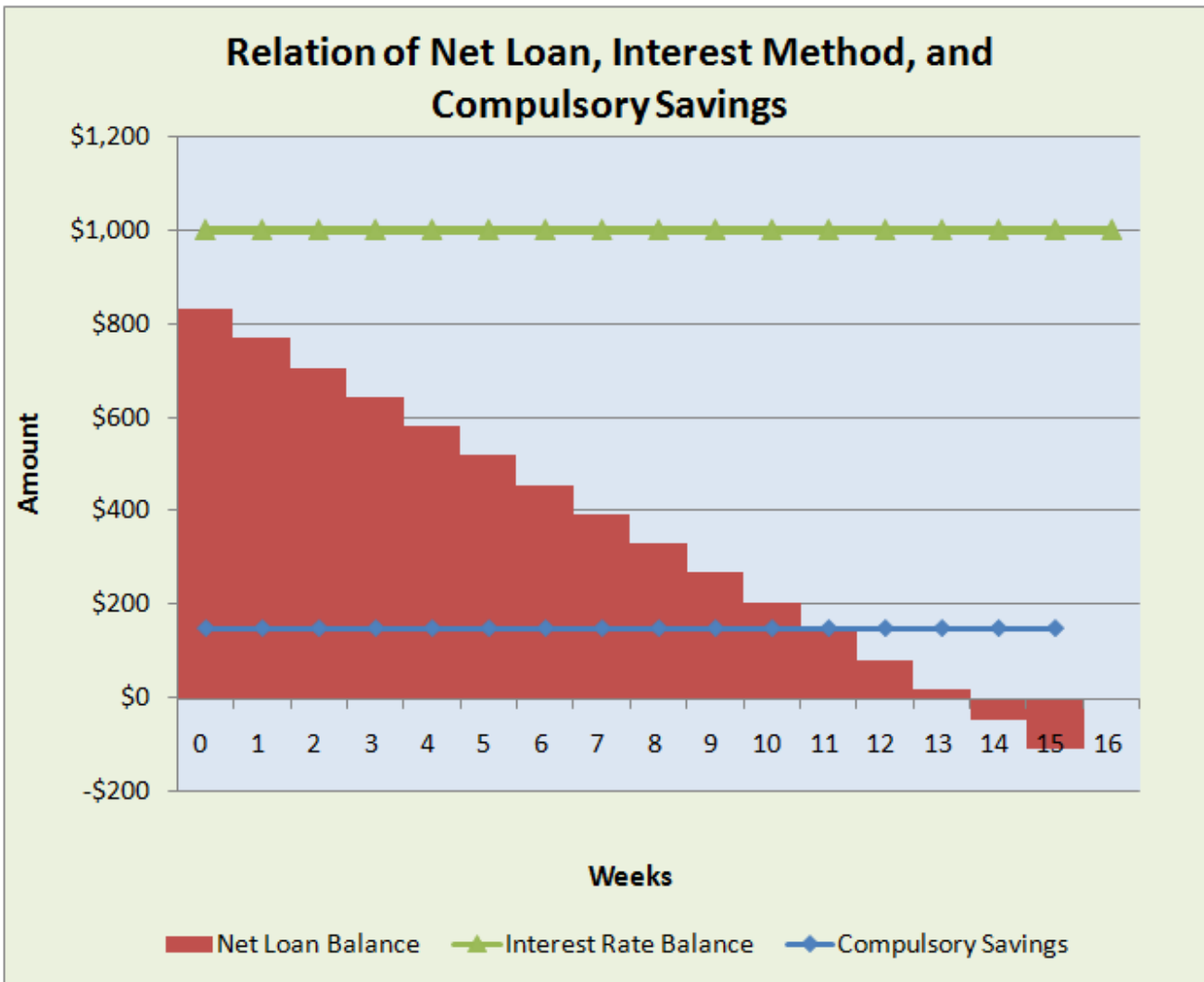
Calculation of APR based on Loan Conditions and Pricing



	Nominal	APR
Ann. Interest	36.0%	65.7%
Int. Method	Flat	
Up-Front Fee	2.0%	78.7%
Savings		78.7%
Savings Int.		

In addition, the client is often charged fees for the loan. In this example, a 2% up-front fee, because of the short loan term, surprisingly adds 13% to the APR. A loan advertised as 36% interest is now the equivalent of 78% APR.

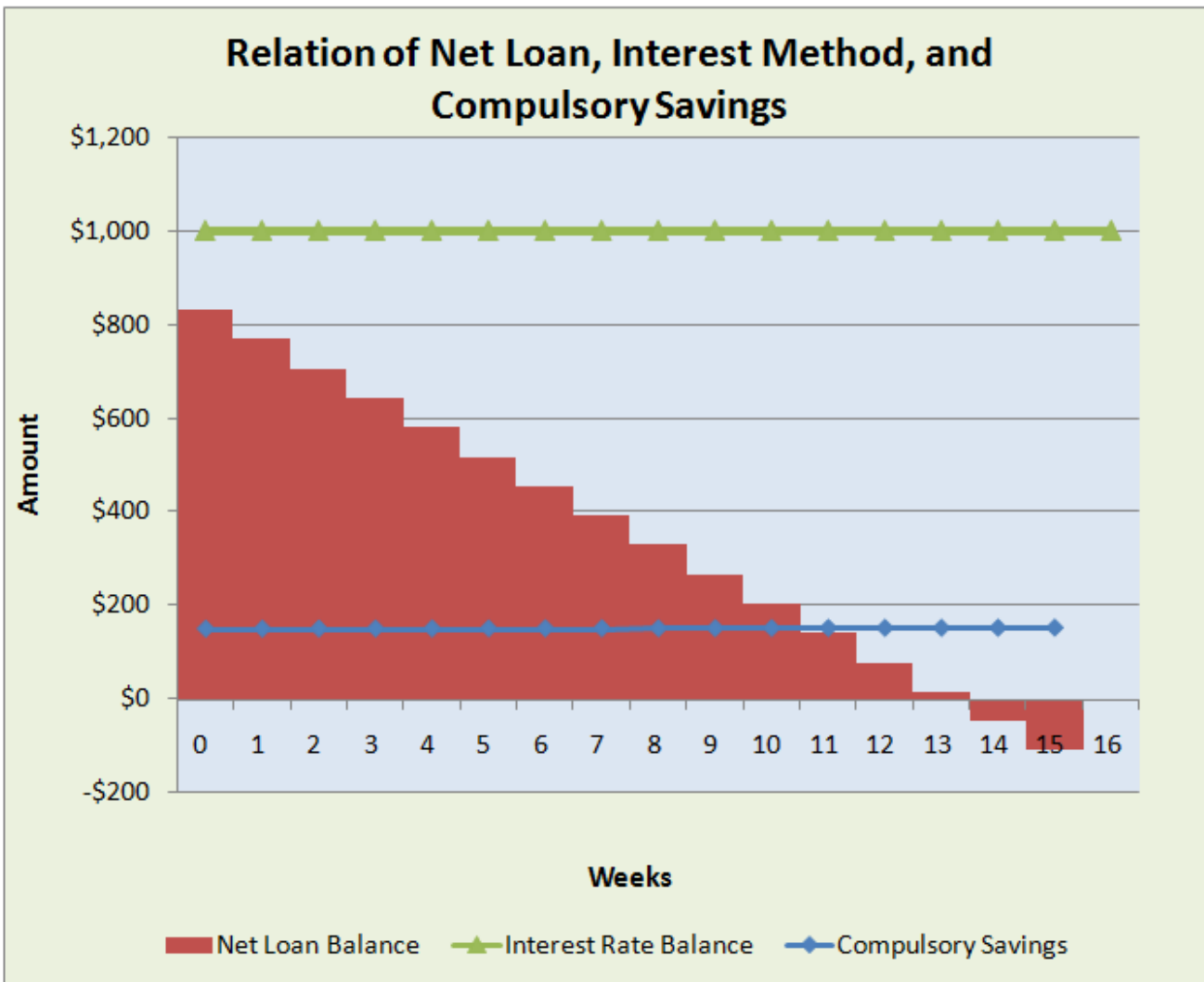
Calculation of APR based on Loan Conditions and Pricing



	Nominal	APR
Ann. Interest	36.0%	65.7%
Int. Method	Flat	
Up-Front Fee	2.0%	78.7%
Savings	15.0%	107.0%
Savings Int.		

Compulsory savings adds to the cost. Clients are charged interest on the original loan (\$1000) even though they never have use of that amount. In this example, the APR is now 107%.

Calculation of APR based on Loan Conditions and Pricing

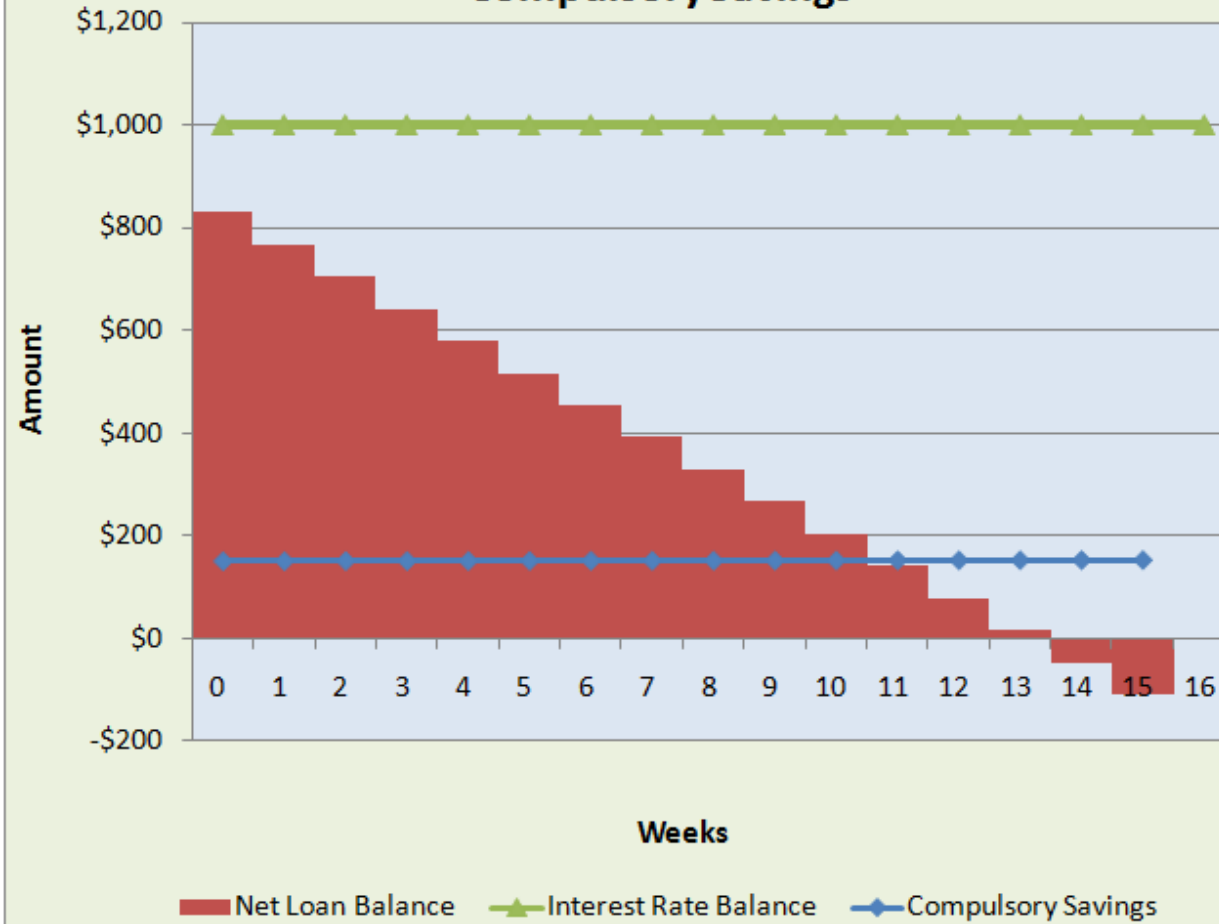


	Nominal	APR
Ann. Interest	36.0%	65.7%
Int. Method	Flat	
Up-Front Fee	2.0%	78.7%
Savings	15.0%	105.5%
Savings Int.	5.0%	

Clients are paid interest, but significantly less interest on their savings than they are charged on their loans. When earning 5% interest, the APR only drops from 107% to 105%.

Calculation of APR based on Loan Conditions and Pricing

Relation of Net Loan, Interest Method, and Compulsory Savings



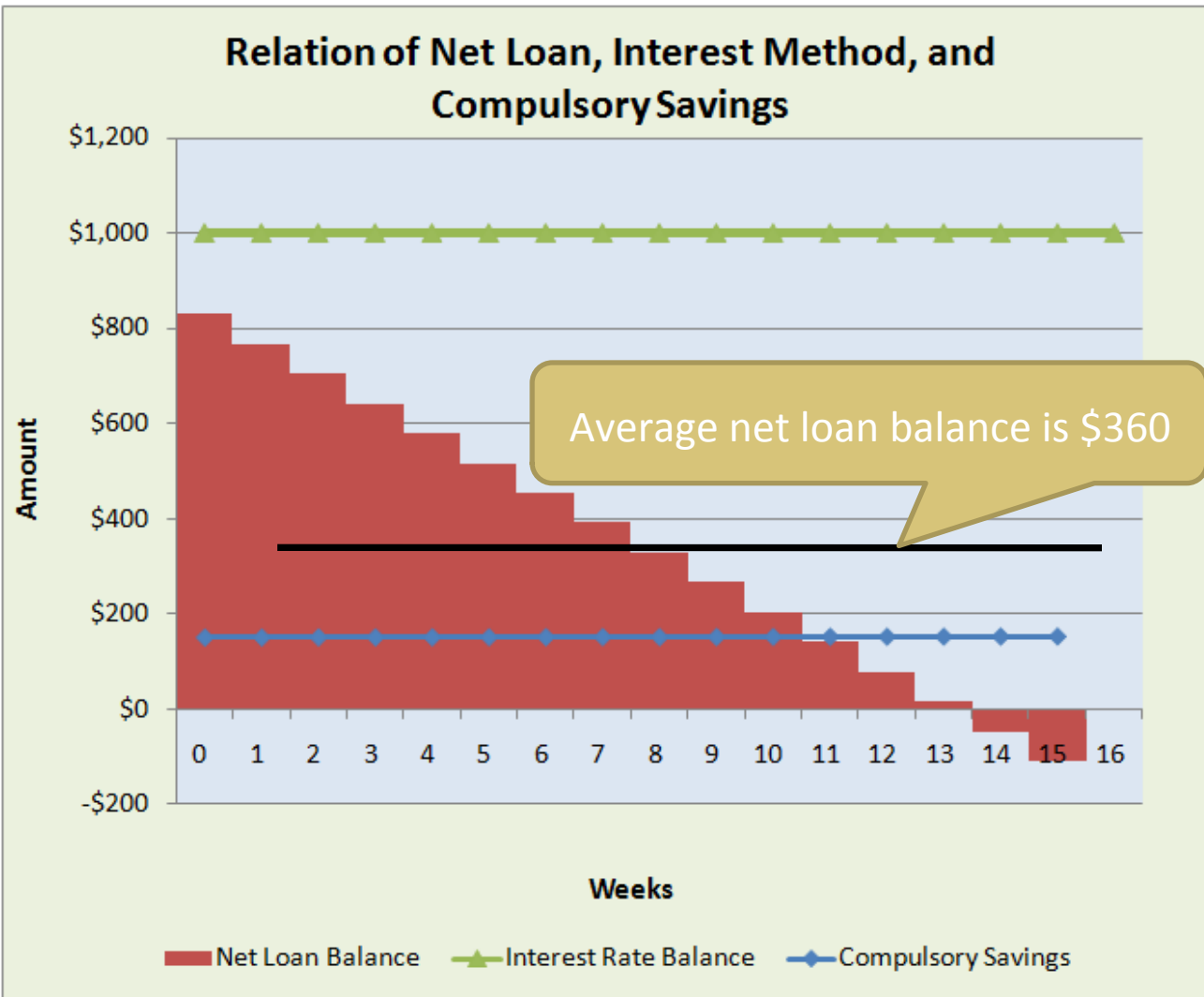
	Nominal	APR
Ann. Interest	36.0%	65.7%
Int. Method	Flat	
Up-Front Fee	2.0%	78.7%
Savings	15.0%	105.5%
Savings Int.	5.0%	

Total Cost	\$131
Annualized	\$425

Avg Balance	\$360
-------------	-------

In this example, the client pays a total cost of \$131 for the \$1,000 loan for 16 weeks. If she were to renew the loan consistently for an entire year, she would pay a total of \$425 for the year.

Calculation of APR based on Loan Conditions and Pricing



	Nominal	APR
Ann. Interest	36.0%	65.7%
Int. Method	Flat	
Up-Front Fee	2.0%	78.7%
Savings	15.0%	105.5%
Savings Int.	5.0%	

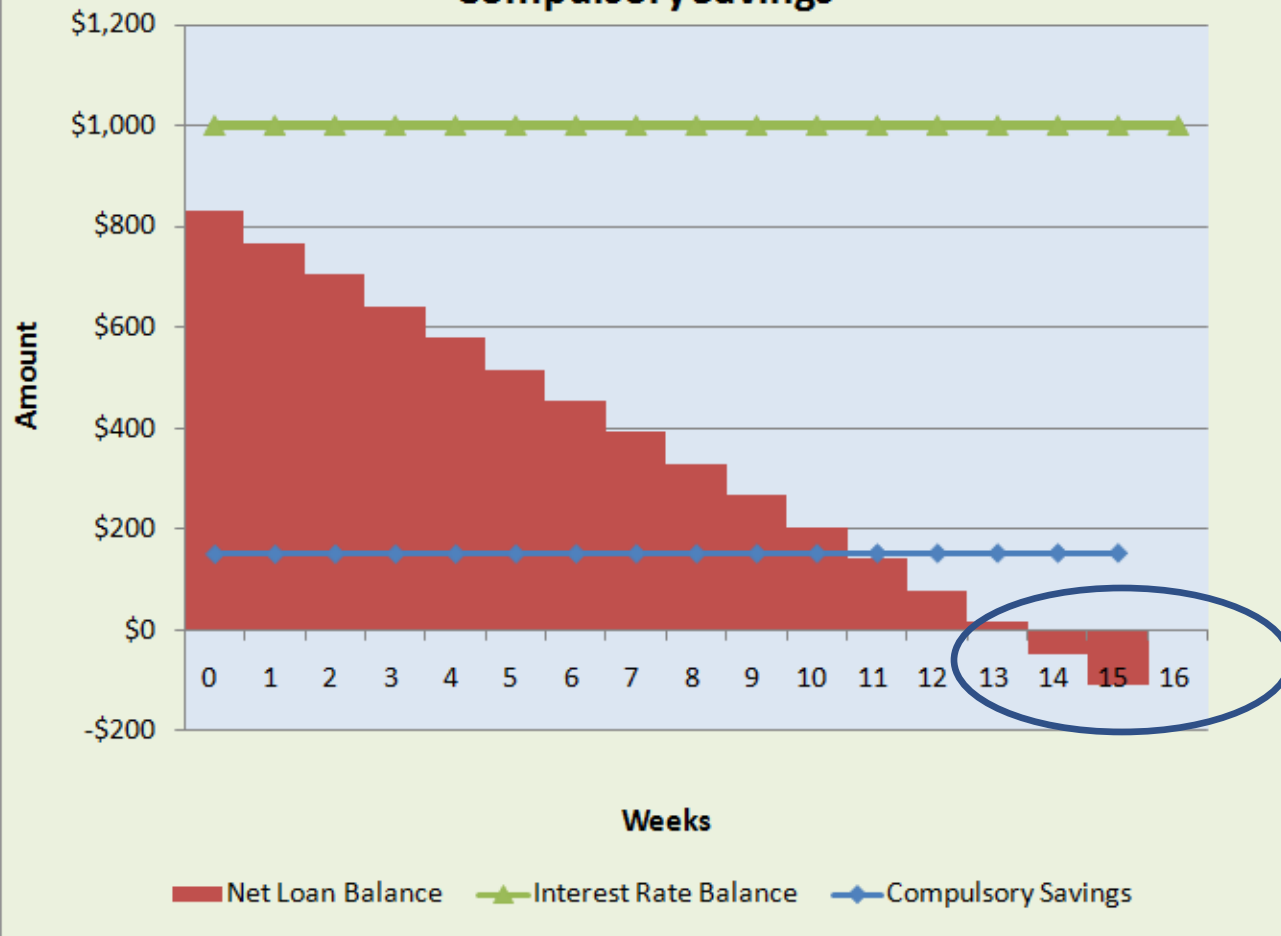
Total Cost	\$131
Annualized	\$425

Avg Balance	\$360
-------------	-------

But, the client never had a \$1,000. She only received \$850 because of the savings, and then she paid back a portion each week. She paid \$425 to have an average loan balance of \$360 for a year, giving an APR greater than 100%.

Calculation of APR based on Loan Conditions and Pricing

Relation of Net Loan, Interest Method, and Compulsory Savings



	Nominal	APR
Ann. Interest	36.0%	65.7%
Int. Method	Flat	
Up-Front Fee	2.0%	78.7%
Savings	15.0%	105.5%
Savings Int.	5.0%	
Total Cost	\$131	
Annualized	\$425	
Avg Balance	\$360	

And with compulsory savings there are some months in which the client actually has more money in savings than invested in her business, giving a *negative* net loan balance.

Which loan looks less expensive?

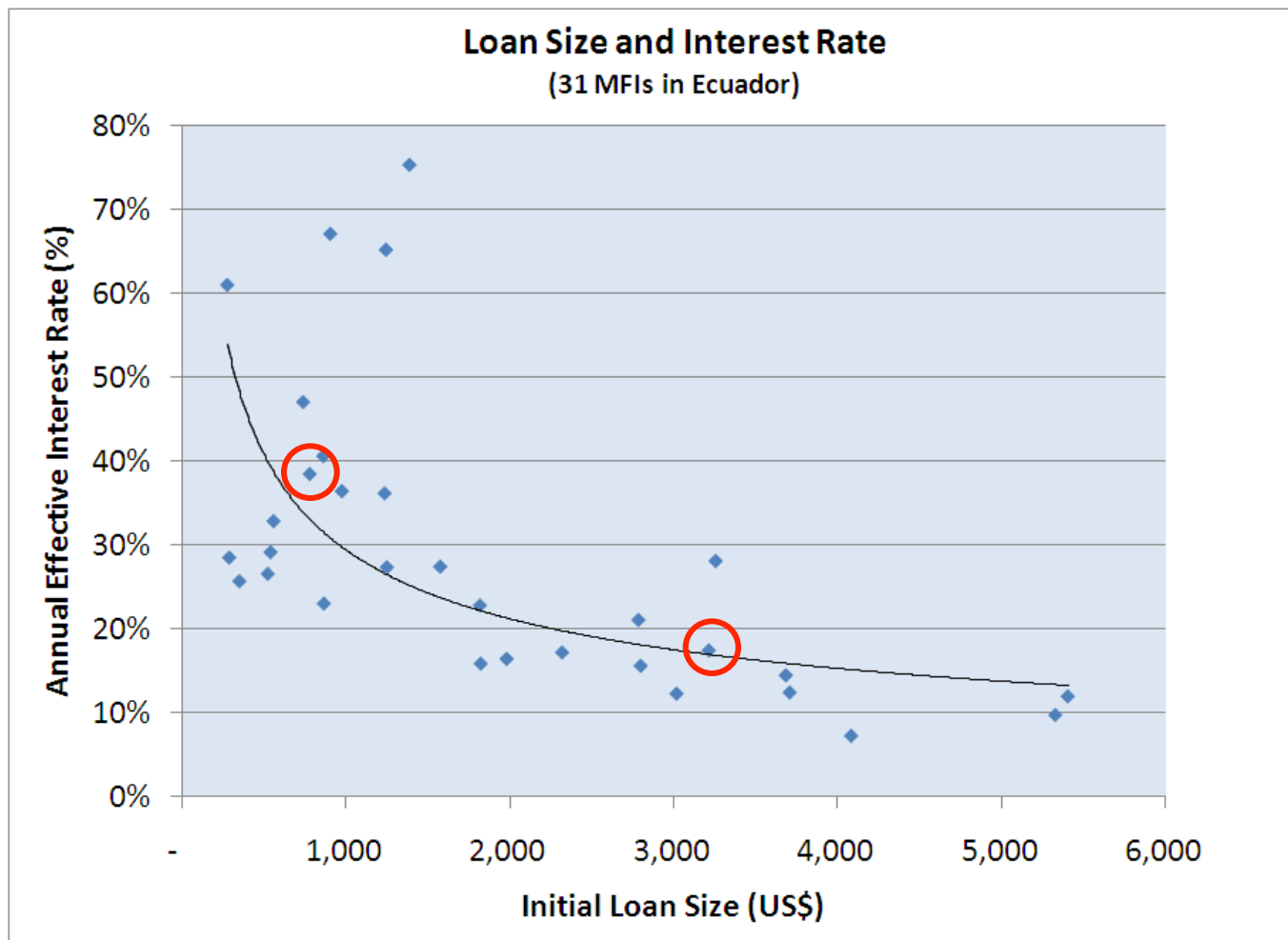
Loan Product	Initial Loan Amount	Total Cost	Length of Loan	APR
Loan Option A	\$1,000	\$131	16 weeks	79%
Loan Option B	\$511	\$425	12 months	79%
Loan Option C	\$360	\$425	12 months	105%

The three products we were comparing are actually **identical in financial terms.**

Loan C includes cost of compulsory savings in the APR calculation.

Why has microfinance practiced and tolerated such universal non-transparency?

How do you easily explain why your MFI charges twice the APR of another MFI?

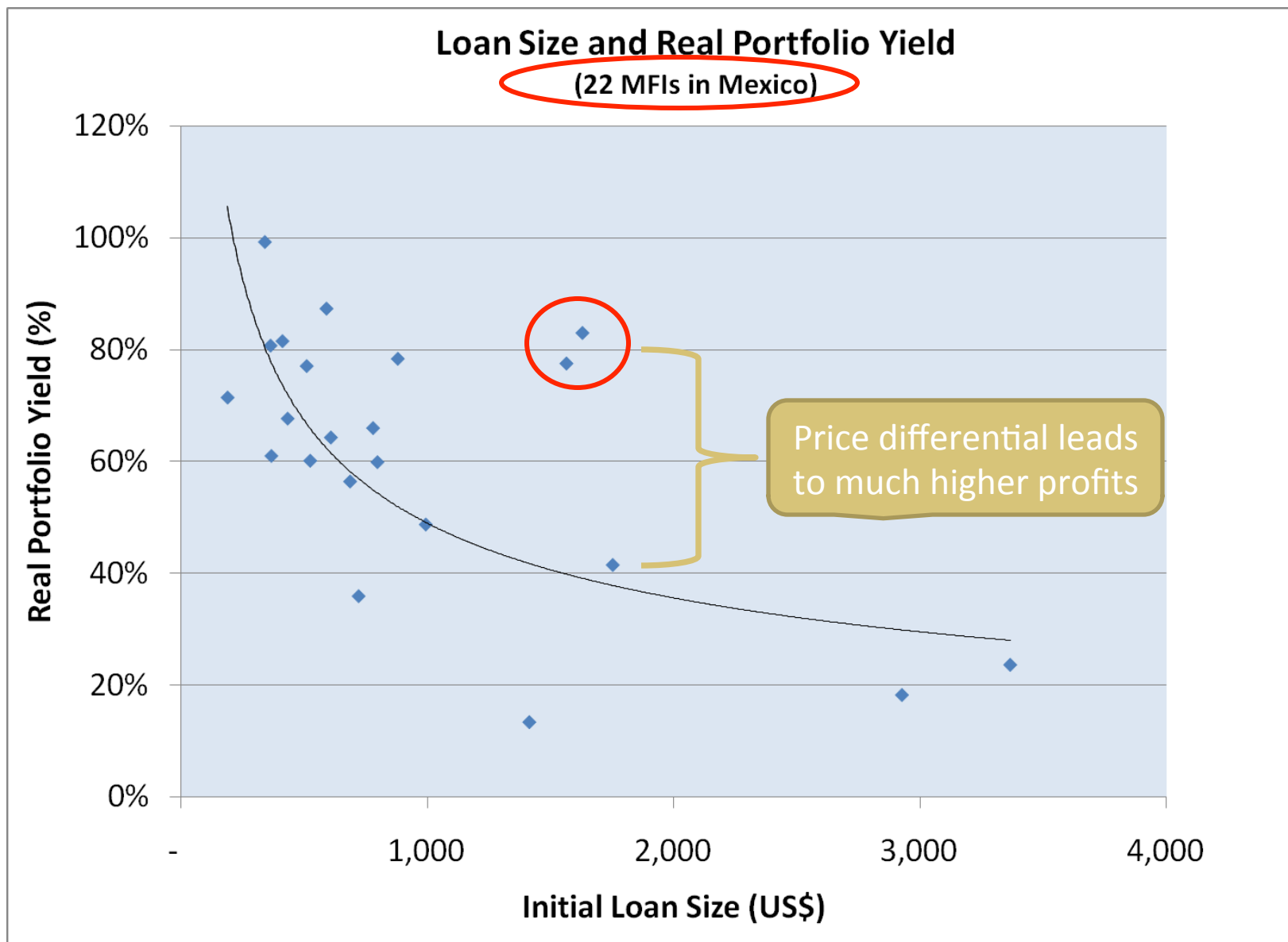


Why has microfinance practiced and tolerated such universal non-transparency?

- There is no “**single interest rate**” for microfinance products
- MFIs have **very different products** and they need to be priced very differently
- **Difficult to communicate** and educate the public about these issues
- I believe, therefore, that this is **the major reason for non-transparent pricing** in microfinance

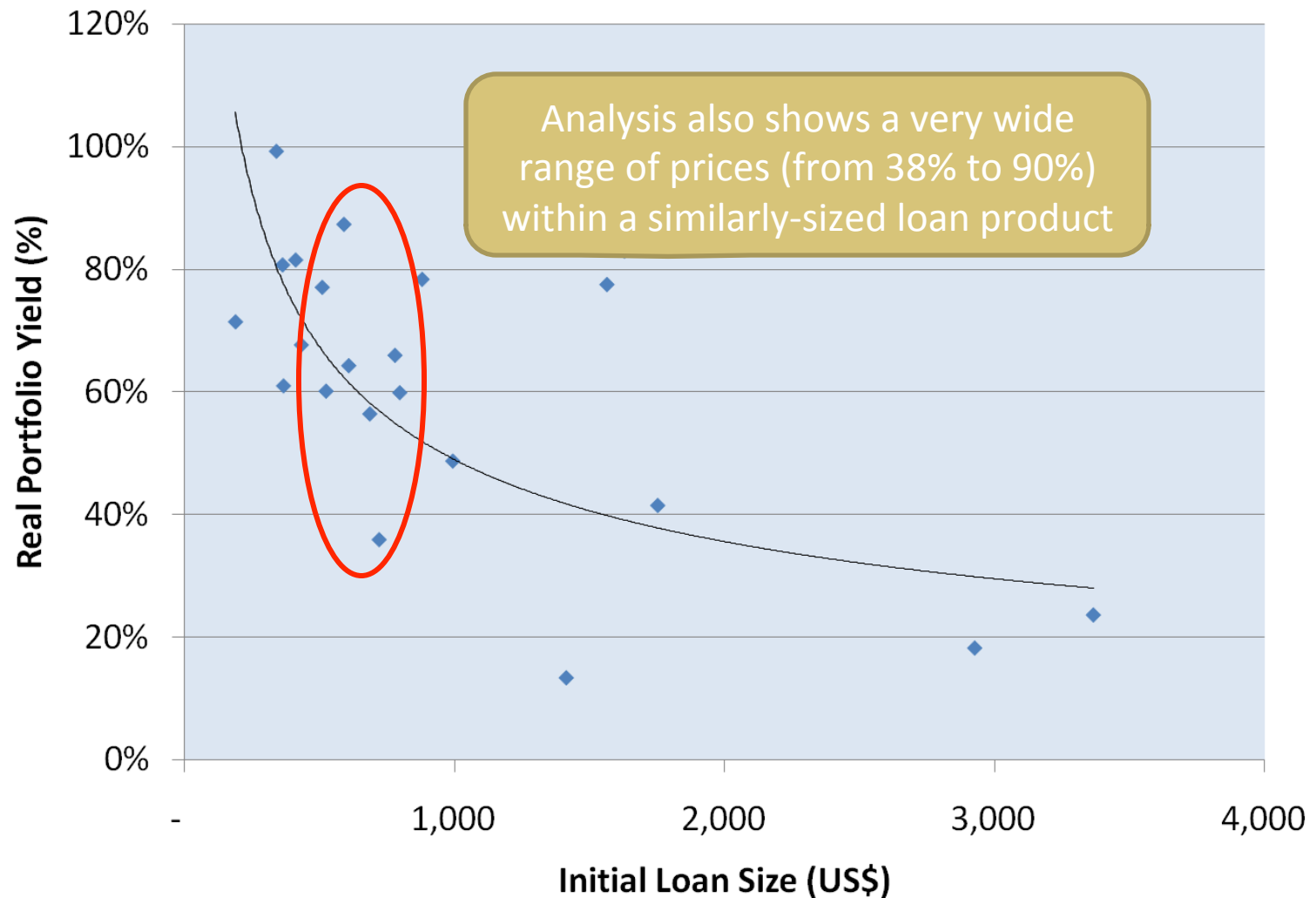
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Analysis shows that some MFIs charge interest rates outside of the normal range

Loan Size and Real Portfolio Yield (22 MFIs in Mexico)



A Significant Industry Turning Point

- » What the industry has done up to the present:
 - Decades of **innovation and testing**, resulting in dramatic success
 - *Strong* efforts to raise a **solid public image** of microfinance as a noble means to lift the poor out of poverty
 - *Strong* efforts to **attract investor money** into the industry
 - *Weak* **efforts in consumer protection** policies and transparency
- » What are the implications of our actions?
 - » We have laid the groundwork attracting a new contingent of actors to enter the industry, but we have neglected to build any serious checks-and-balances necessary to protect the poor

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How can the industry advocate pricing transparency?

- We should implement **self-imposed “truth-in-lending”** rather than wait for governments to impose such behavior
- We should **publish APR-equivalent interest rates** for all products of all MFIs in a given market
- We should work at **educating the public** on why interest rates justifiably vary significantly based on loan size

MFTransparency Goals

- *MFTransparency* will enable transparent communication between all microfinance stakeholders about **credit products and their prices** in a clear and consistent fashion.
- The *MFTransparency* website will incorporate **educational material** on the concept and function of interest rates and product pricing.

Who will monitor MF*Transparency* Info?

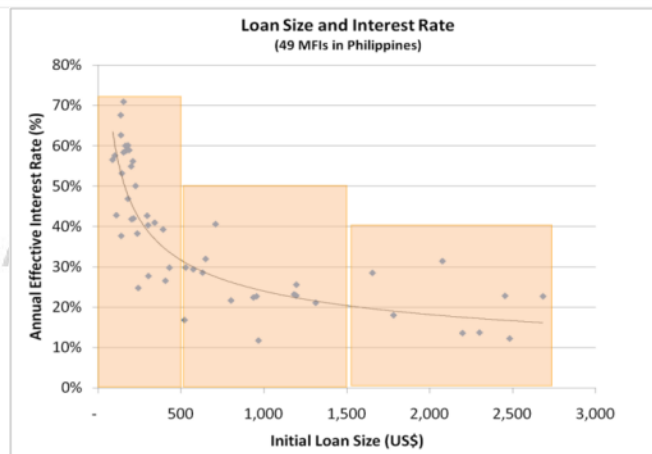
“MFIs will find the service of MFTransparency very helpful. Investors, donors, policy makers, researchers, and practitioners will immensely benefit from their service.”

Muhammad Yunus, Managing Director, Grameen Bank

“MF Transparency aims at giving MFIs information to offer better value to customers. And it will give investors and others the information they need to put pressure on those institutions that may be charging unreasonably high fees or hiding the full cost of their services. We applaud the effort.”

Elizabeth Littlefield, CEO, CGAP

Interest Rates in Ecuador



Summary: Loan Classes in Ecuador

Loan Class	Sample Amount	Lowest	Average	Highest	Avg Duration
0-\$1000	\$500	23%	42%	67%	6 months
\$1000-\$2000	\$1500	15%	23%	75%	9 months
\$2000-\$6000	\$4000	8%	17%	23%	18 months

Typical Rates

Interest Rates are typically higher for smaller loans. Because agencies still have to cover the same fixed costs of loan administration, smaller loans tend to have higher rates than larger loans.

Other Factors

Borrowers may be willing to pay a higher interest rate to organizations that offer more convenience or other features such as:

- ▣ feature 1
- ▣ feature 2
- ▣ feature 3

MFI and Product Names		Product Description			Breakeven Point Analysis		
MFI	Product	Typical Initial Loan Amt	Typical Term (months)	APR	Avg Loan Balance	Cost paid in 12 months	Breakeven Point (months)
XYZ.org	Education Working Capital	\$150	49 months	107%	\$108	\$150	8.7
ABC.org	Emergency Group \$1247	\$250	46 months	49%	\$103	\$64	19.2
DEF.org	Education Individual \$1252	\$600	12 months	32%	\$259	\$104	30.0
RTF.org	Village Bank	\$135	4 months	79%	\$56	\$57	11.6
3AB.org	Business Housing \$1390	\$750	18 months	35%	\$313	\$136	27.7
	Education	\$220	8 months	N/A	--	--	--
DSR.org	waiting response						
CDF.org	Retail	\$200	6 months	N/A	--	--	--

***MFTransparency* Implementation Plan**

- Currently building our base of “endorsers”
- Funding mobilization is nearly complete
- Have data analysis plans and website designs underway
- Currently developing educational materials
- Will implement 8 “pilot countries” in next 6 months
- Will expand coverage to other countries over the following year

MFTransparency Endorser Statement

We started circulating our endorser statement two weeks ago. The statement reads:

“I endorse the dual mission of MFTransparency to:

- Facilitate the collection and dissemination of transparent microcredit product pricing information*
- Educate stakeholders and enhance their understanding of microcredit product pricing.*

I encourage all to support these principles.”

Asia/Pacific Region Endorsers				24,684,500
Name	Title	Organization	Country	Clients
Muhammad Yunus	MD	Grameen Bank	Bangladesh	7,400,000
Fazle Abed	Chair	BRAC	Bangladesh	4,550,000
Shafiquel Haque Choudhury	President	ASA	Bangladesh	5,430,000
Vikram Akula	CEO	SKS	India	1,870,000
Musuku Udaia Kumar	MD	Share	India	990,000
J.S. Tomar	MD	CASHPOR	India	174,000
Jayshree Vyas	MD	Sewa Bank	India	64,000
R.M. Malla	Chair	SIDBI	India	
Bambang Ismawan	Sec.Gen.	Gema PKM	Indonesia	
Sulaiman Arif Arianto	MD	BRI	Indonesia	3,445,000
Shankar Man Shrestha	CEO	MDC	Nepal	
Roshaneh Zafar	President	KASHF	Pakistan	295,000
Kamal Hyat	CEO	PPAF	Pakistan	
Aristotle B. Alip	MD	CARD	Philippines	247,000
Ruben de Lara	ED	TSPI	Philippines	135,000
Cecilia D. del Castillo	ED	NWTF	Philippines	66,500
Gregory Casagrande	Founder	SPBDF	Samoa	18,000

Financing, Ratings, and Industry Policy

Name	Title	Organization	Country
Elizabeth Littlefield	CEO	CGAP	US
Damian von Stauffenberg	ED	MicroRate	US
Matt Flannery	ED	Kiva	US
Shari Berenbach	ED	Calvert	US
Jonathan Lewis	CEO	MC Enterprises	US
Minh Huy Lai	COO	PlaNet Finance	France
Kamal Hyat	CEO	PPAF	Pakistan
Tracey Pettengill Turner	Founder	MicroPlace	US
Asad Mahmood	MD	Deutsche Bank	US
Johannes Sannesmoen	MD (retired)	Stromme Foundation	Norway
Art Avedisian	ED	Cygma	US
Nicola Armacost	MD	Arc Finance, Ltd	US
Zac Pessin	CEO	Distributed Capital Group	US
Jim Deitch	Chair	Hope Global Investment Fund	US

Networks of Microfinance Institutions

Name	Title	Organization	Country
Sam Daley-Harris	Director	Microcredit Summit Campaign	US
Chris Dunford	President	Freedom From Hunger	US
Bambang Ismawan	Secretary General	Gema PKM	Indonesia
Alex Counts	President and CEO	Grameen Foundation USA	US
Rob Dunn	CEO	Opportunity International / Australia	Australia
Peter Greer	President	Hope International	US
R.M. Malla	Chair	SIDBI	India
Shankar Man Shrestha	CEO	MDC	Nepal
Allan Sauder	President	MEDA	Canada
Ed Bland	President	Unitus, Inc	US
David Richardson	Senior Manager	WOCCU	US
Soukeyna BA	Executive Director	INAFI International	Senegal
John Hatch	Co-Founder (retired)	Microcredit Summit Campaign	US

Academic / Consultants

Name	Title	Organization	Country
Malcolm Harper	Professor	Cranfield School of Managment	UK
Eugene A. Ludwig	Chair	Promontory Interfinancial Network	US
Herman Abels	Founder	Alliance for Fair Microfinance	Holland
Narasimhan Srinivasan	GM (Former)	NABARD	India
Du Xiaoshan	Professor	Rural Development Institute	China
Dale Adams	Professor	Ohio State University	US
David Miller	Board	CED/SNHU	US

A long-overlooked need

“We have made major investments in improving the quality and clarity of information on microfinance institutions. But we have not yet invested as much as we should in making sure costs of financial services for poor clients are clear and fair.

MFTransparency’s initiative is a bold one that promises to fill an important gap.”

Elizabeth Littlefield, Director and CEO, CGAP

MFTransparency Endorser Statement

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I endorse the dual mission of MFTransparency to:

- ☒ Facilitate the collection and dissemination of transparent microcredit product pricing information.
- ☒ Educate stakeholders and enhance their understanding of microcredit product pricing.

I encourage all who are involved in the microfinance industry to support these principles.

(signature)

(name printed)

(job title)

(organization)

(email address)

(date)

Please read, sign, and return this form to MFTransparency. Email a scanned copy to info@mftransparency.org or fax to 212-243-7558.

MFTransparency will

- provide a forum for the microfinance industry to publicly demonstrate its commitment to pricing transparency;
- enable the free flow of pricing information among providers, consumers, and all microfinance stakeholders; and
- help educate all microfinance stakeholders to understand interest rates and product pricing.

*We want to hear from you.
Please contact us with your questions
or suggestions by emailing
feedback@mftransparency.org.*



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info@mftransparency.org

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*Promoting transparent pricing
in the microfinance industry*

