

# Why We Need Transparent Pricing in Microfinance

Chuck Waterfield  
MicroFinance Transparency  
May 2009

 **mftransparency.org**

# The Good News in October 2006

## BusinessWeek

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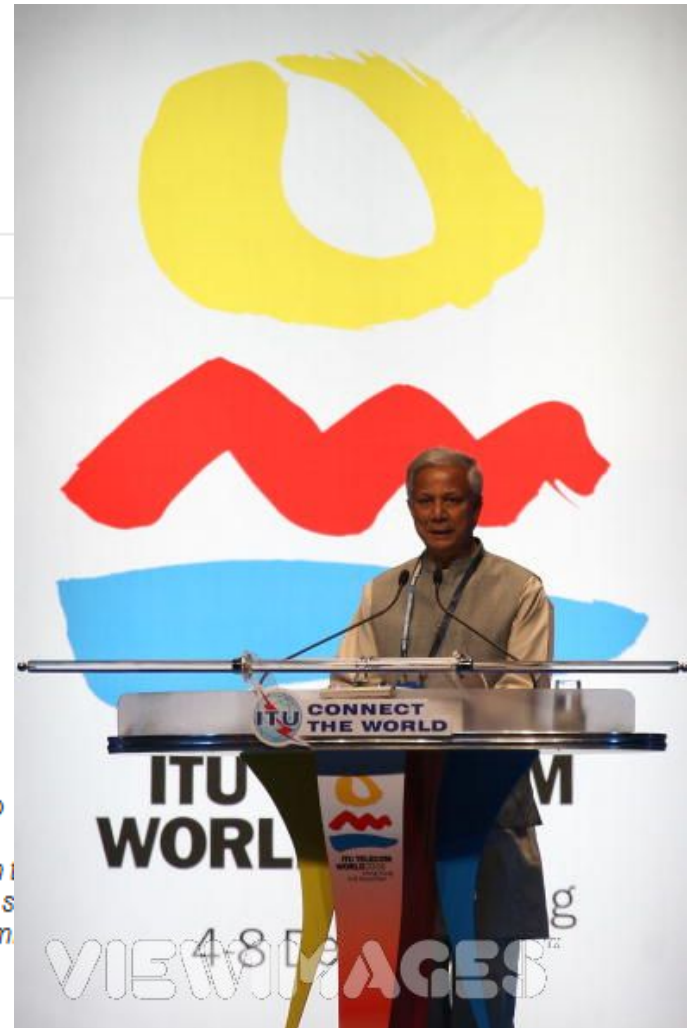
Customer Service

Full Table of Contents  
Cover Story  
International Cover Story  
Up Front  
Readers Report  
Corrections &  
Clarifications  
Voices Of Innovation  
Technology & You  
Media Centric  
The Barker Portfolio  
Business Outlook

### 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 social progress in the world."*



# ... and the bad press a year later



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## Magazine



### 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

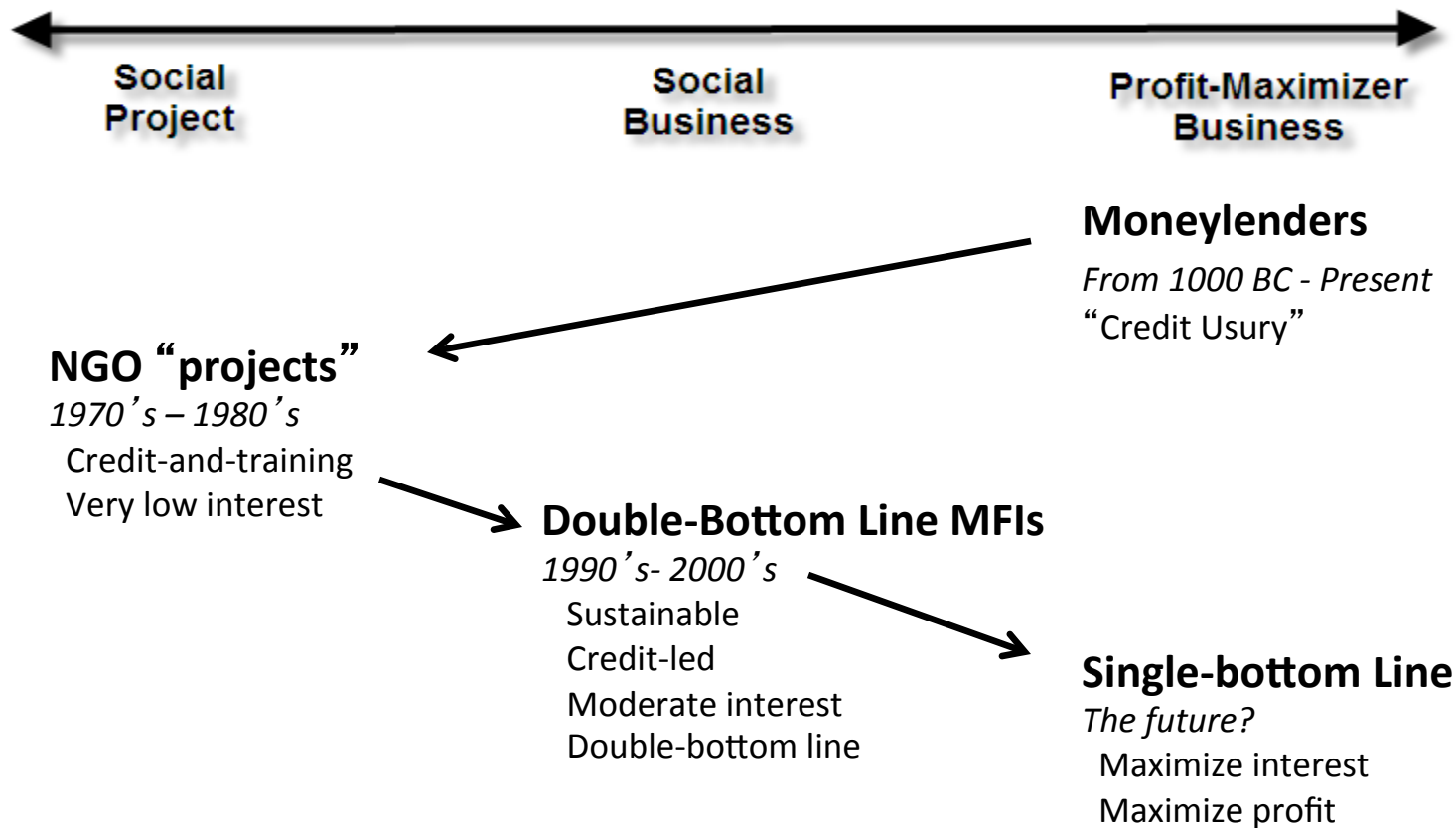
# Interest rates quoted in Business Week

(citing US-APR figures, not EIR)

- Compartamos (leading MFI): 105%
- Banco Azteca (consumer finance): 90%
- Wal-Mart (corporation): 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

# Financial Services for the Poor

## 3000 years on one slide



# The Poor and Credit

- The poor have *always* had access to credit... for a price!
- Microfinance was born to provide a **low-cost alternative** to the moneylenders
- Ironically, we have unintentionally created a confusing environment where **nobody *knows* the true price of microcredit products**

# Four Key Points on Pricing Transparency

1. **Interest rates** vary significantly relative to **loan size**, making transparency difficult
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

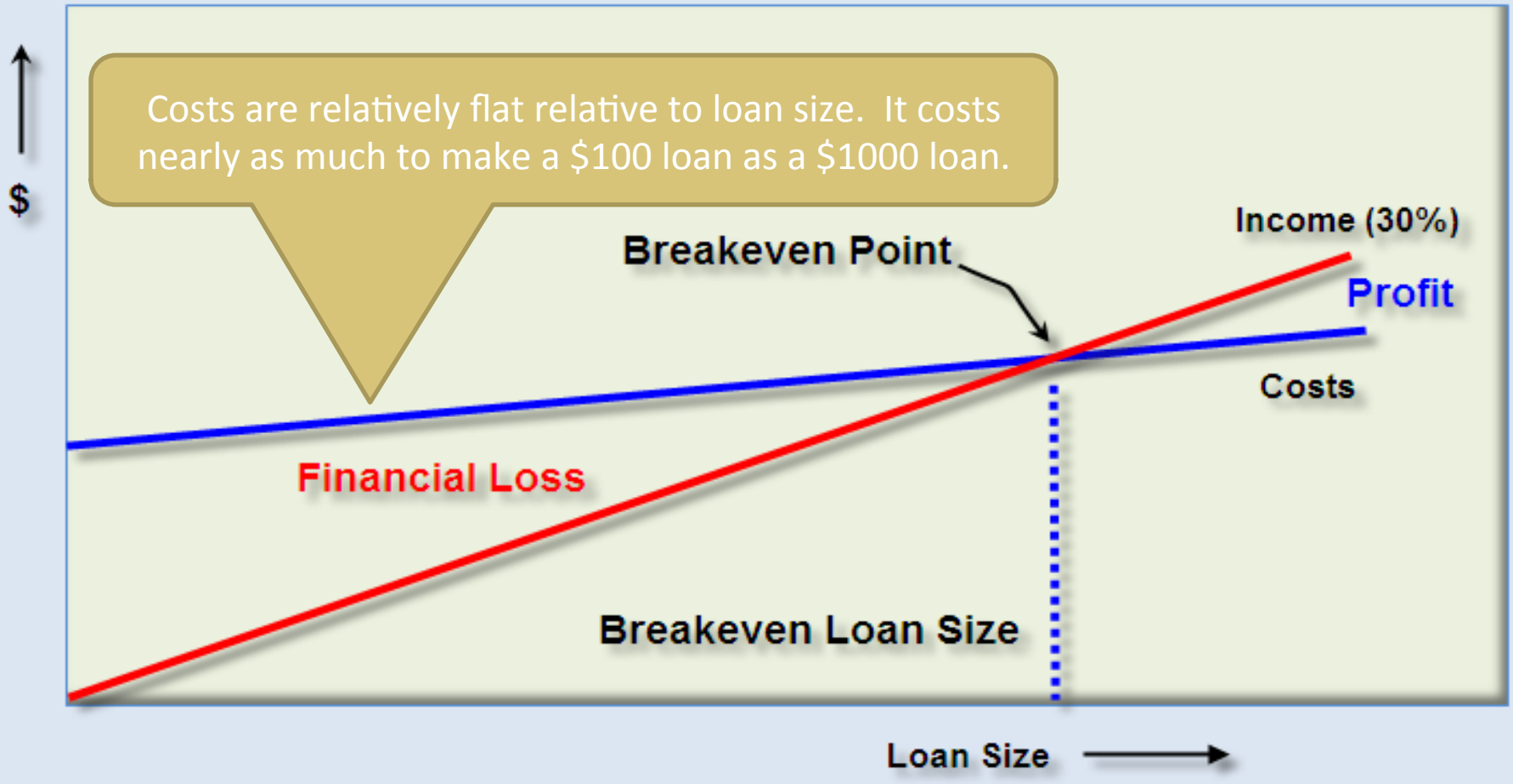


# Four Key Points on Pricing Transparency

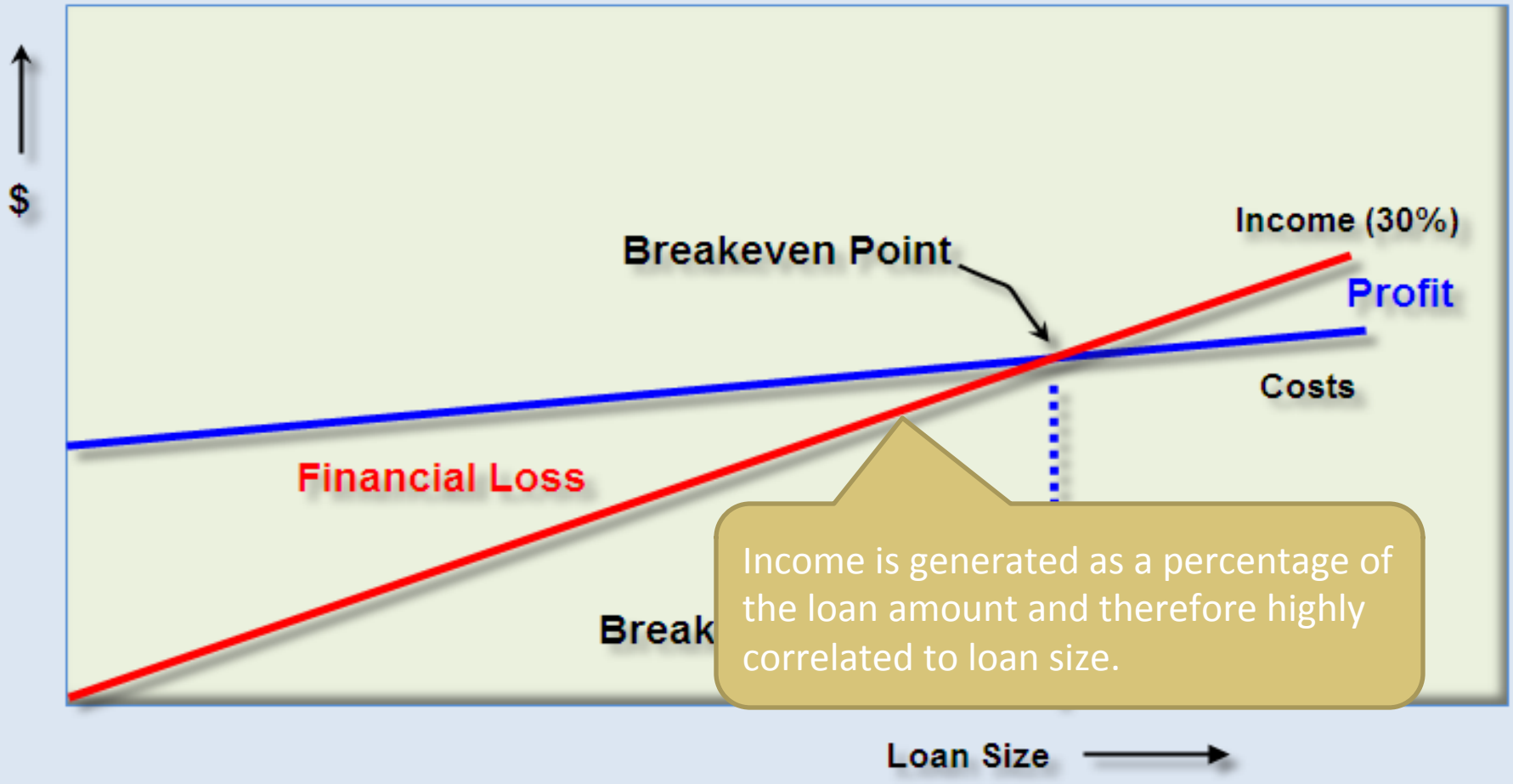
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## Breakeven Points related to Loan Size and Interest Rate

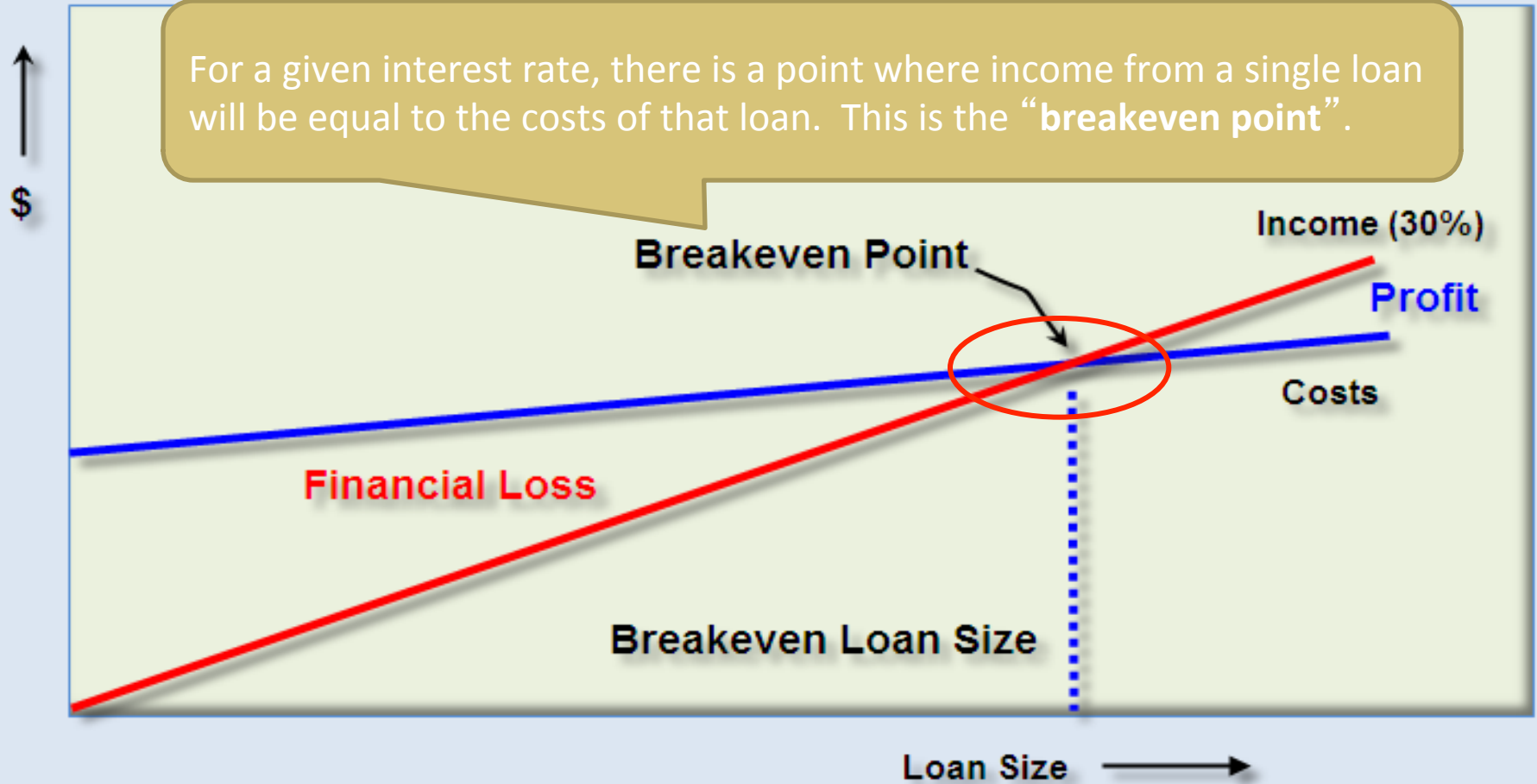


### Breakeven Points related to Loan Size and Interest Rate

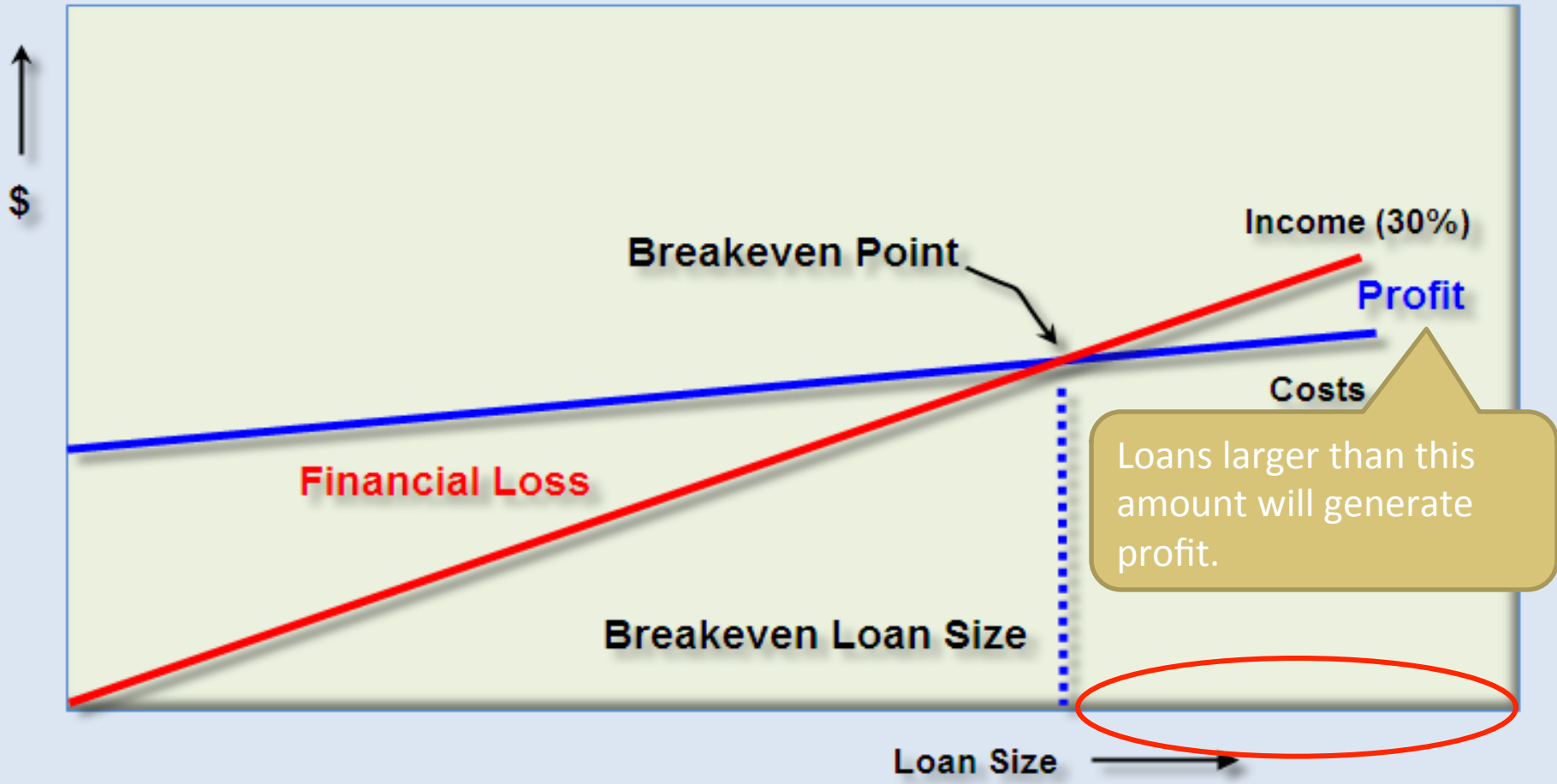


## Breakeven Points related to Loan Size and Interest Rate

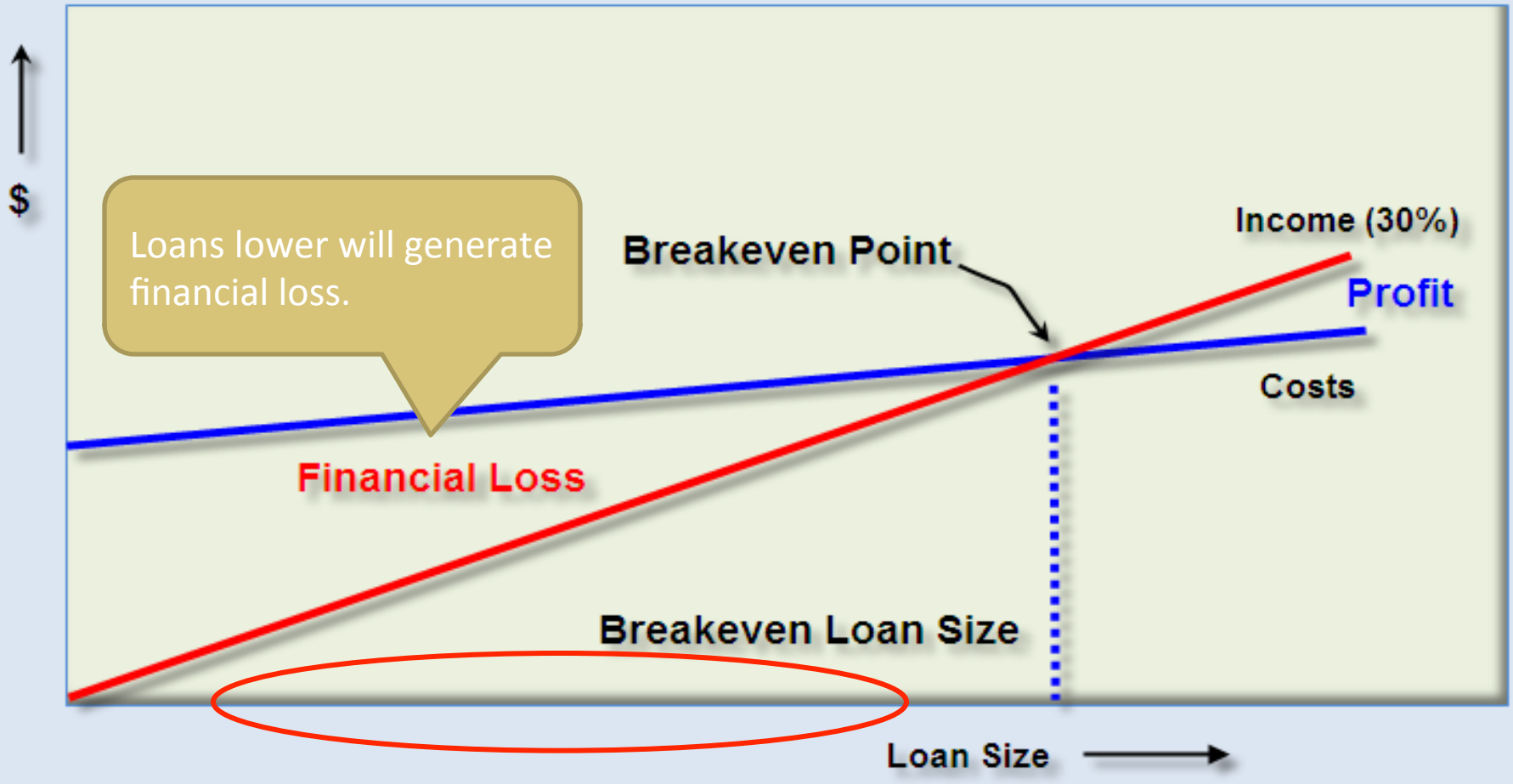
For a given interest rate, there is a point where income from a single loan will be equal to the costs of that loan. This is the “breakeven point”.



### Breakeven Points related to Loan Size and Interest Rate



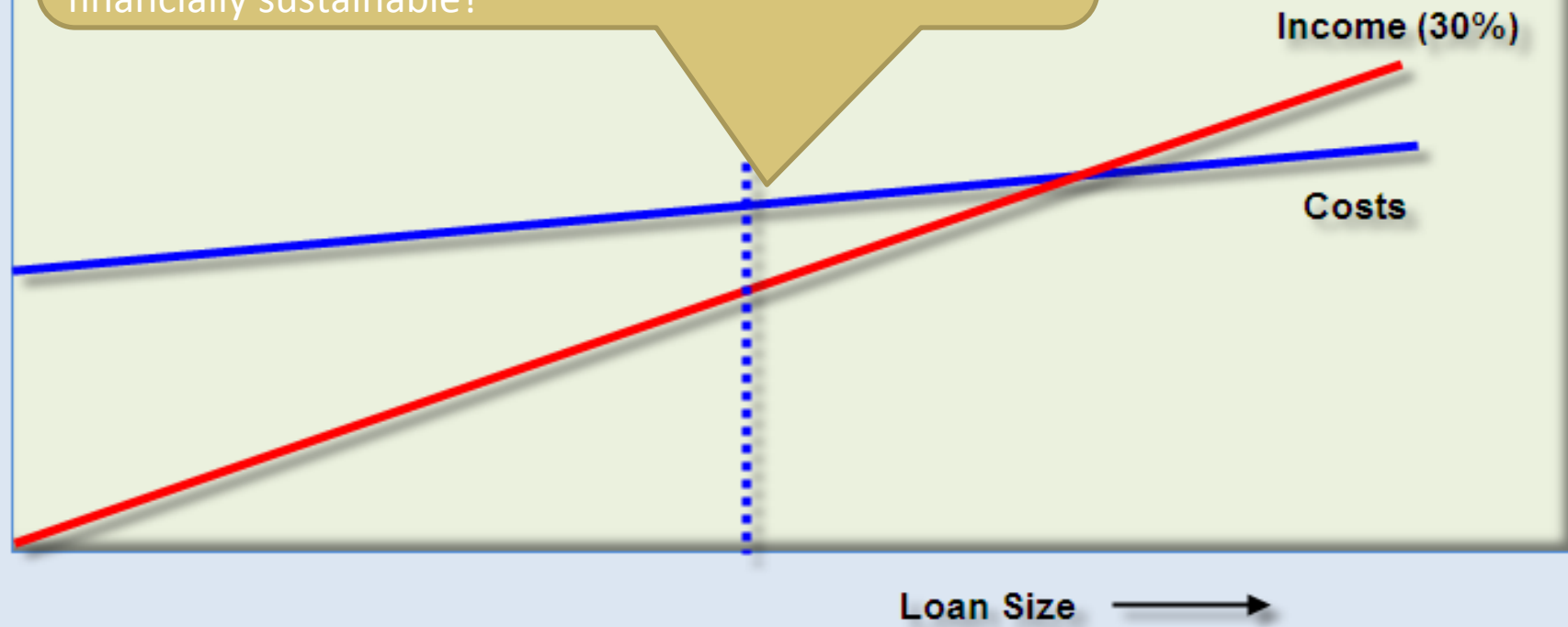
### Breakeven Points related to Loan Size and Interest Rate



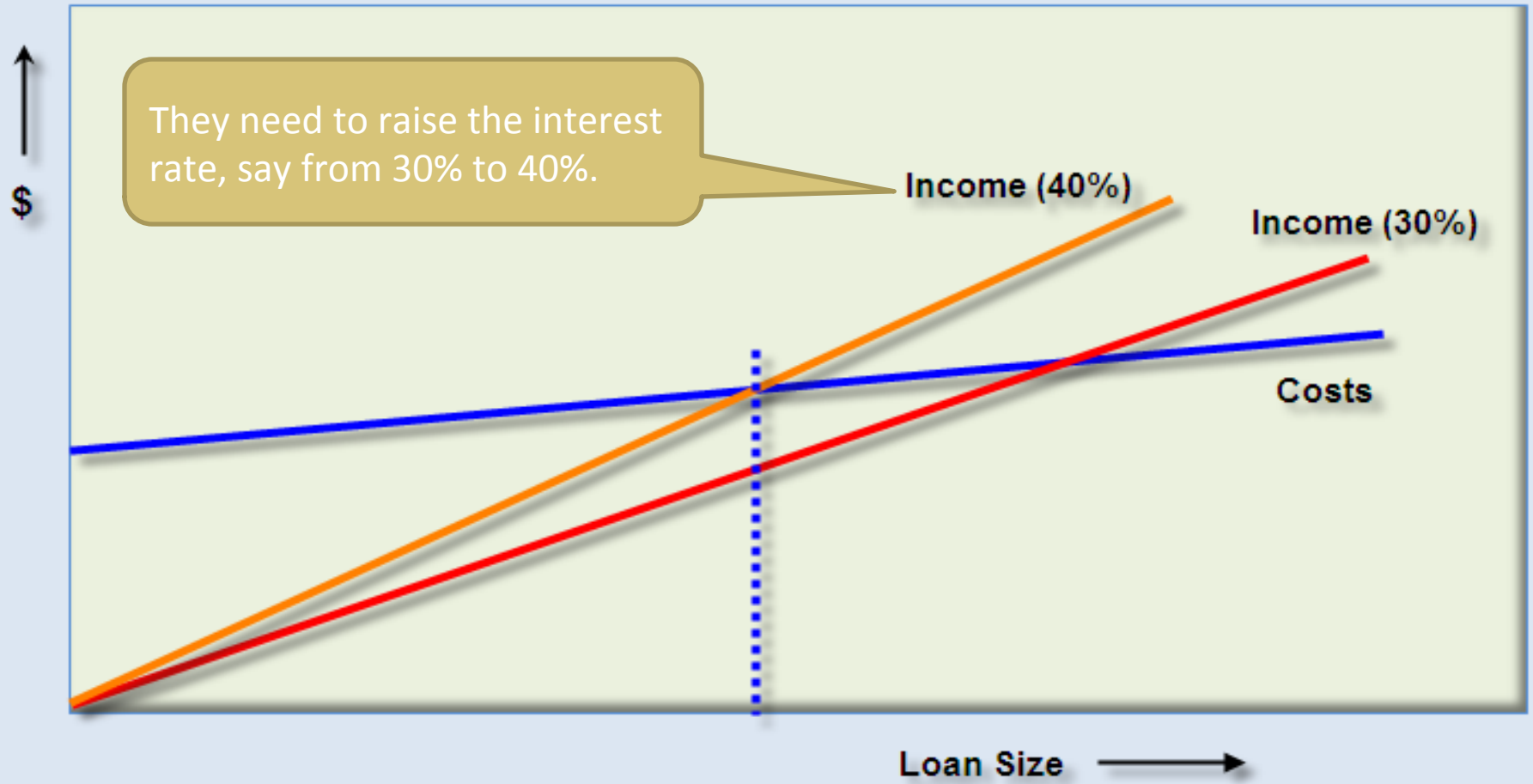
## Breakeven Points related to Loan Size and Interest Rate

↑  
\$

If an institution wants to deliver smaller loans at the same interest rate, they will lose money. What must they do if they want to make these smaller loans financially sustainable?



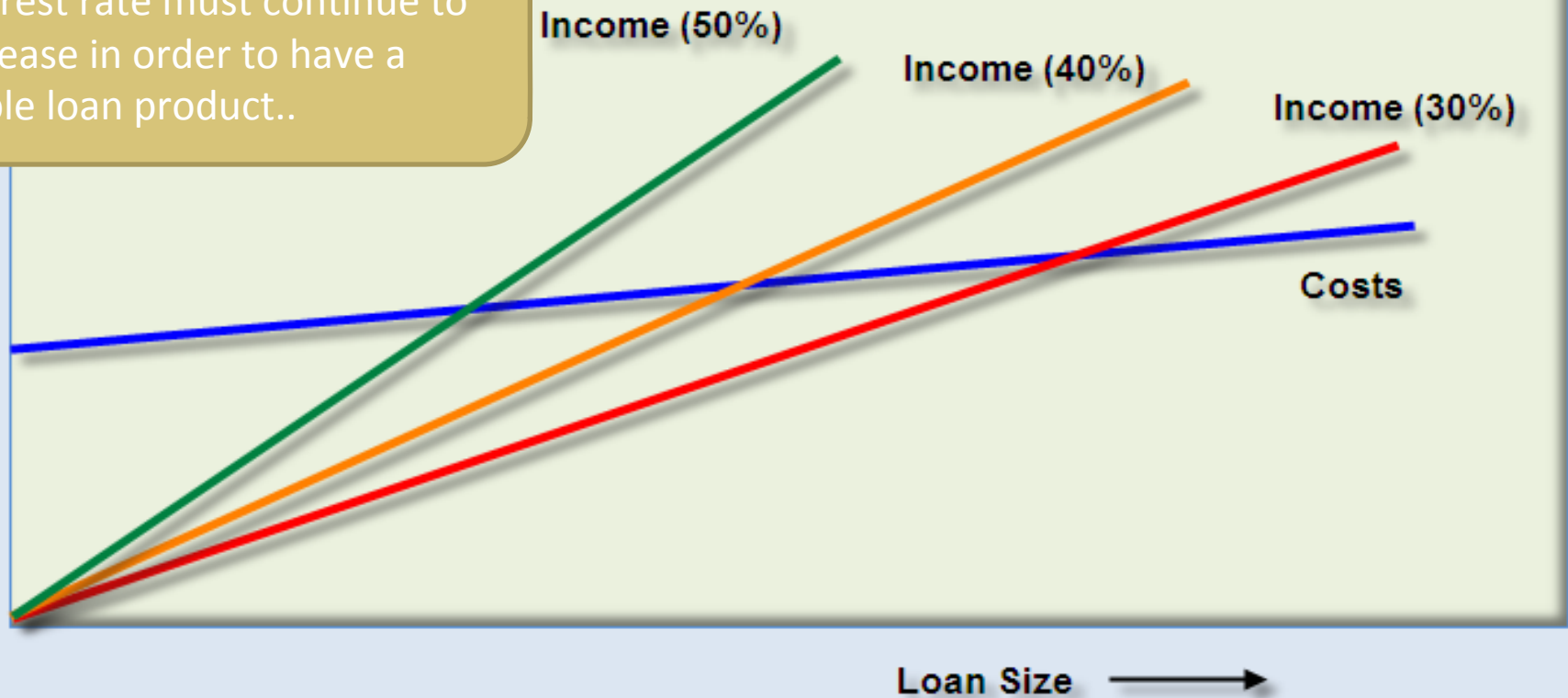
### Breakeven Points related to Loan Size and Interest Rate



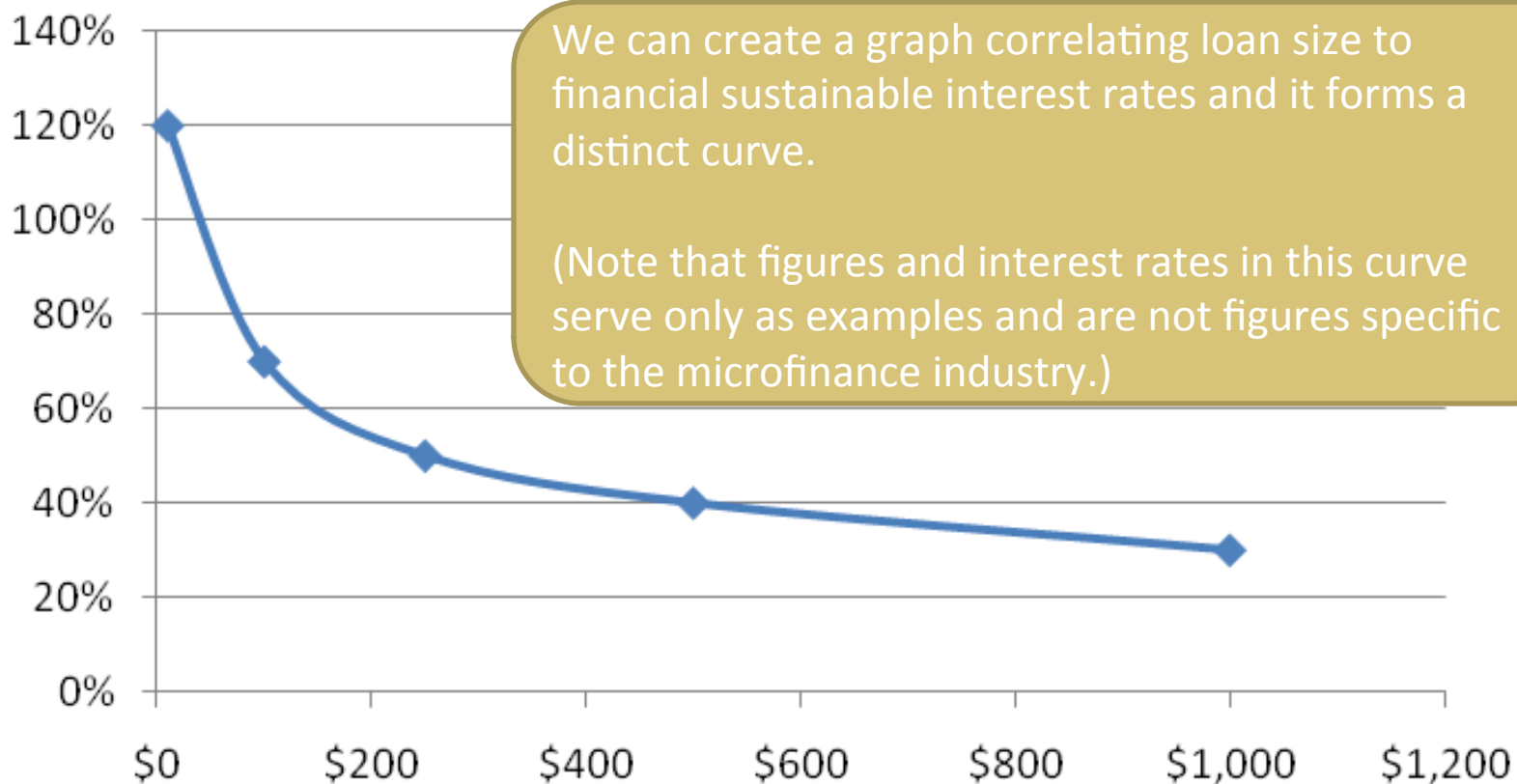


## Breakeven Points related to Loan Size and Interest Rate

As the loan size decreases, the interest rate must continue to increase in order to have a viable loan product..



## Interest Rate and Loan Size

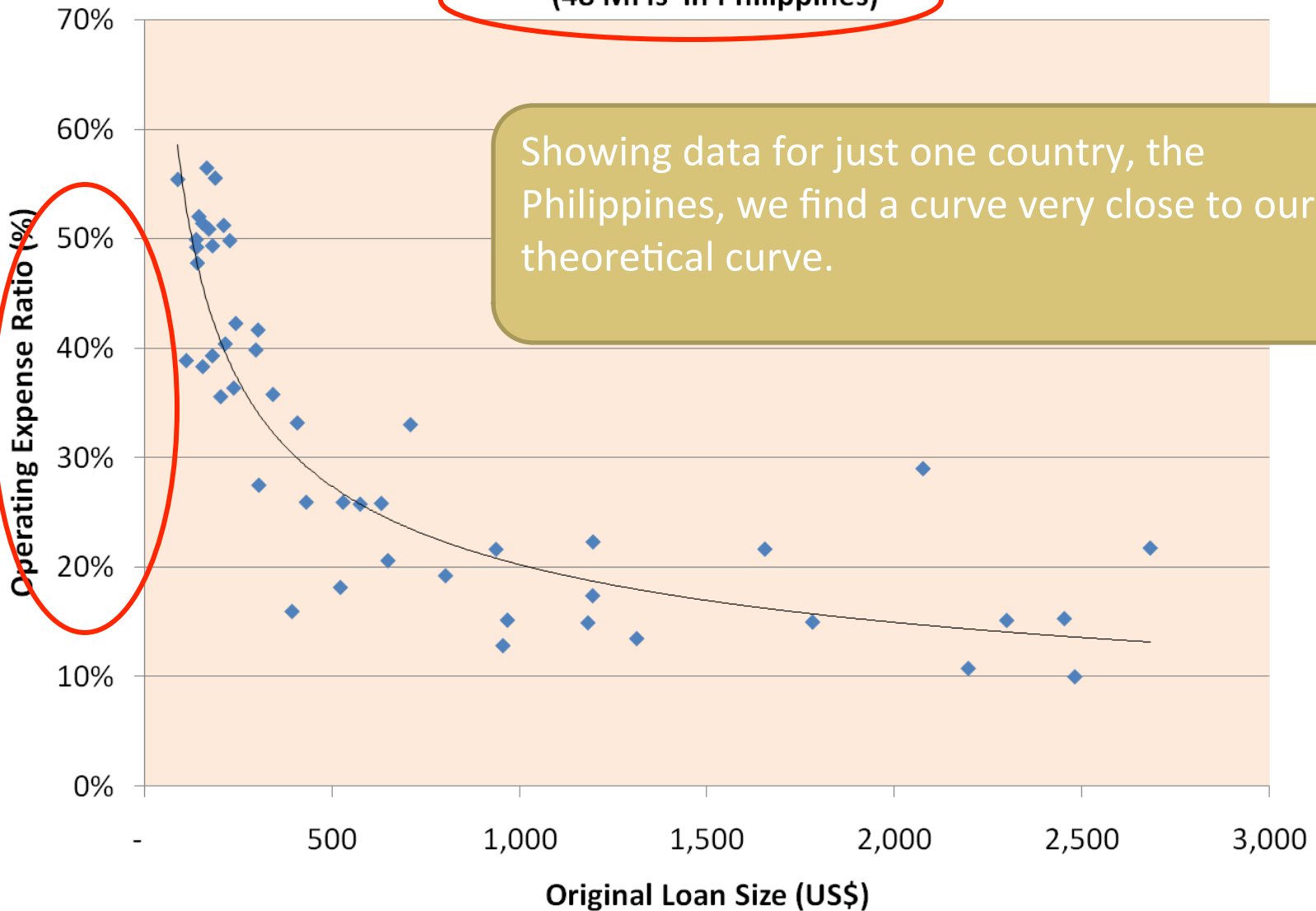


Higher costs for smaller loan amounts require significantly higher interest rates for sustainability

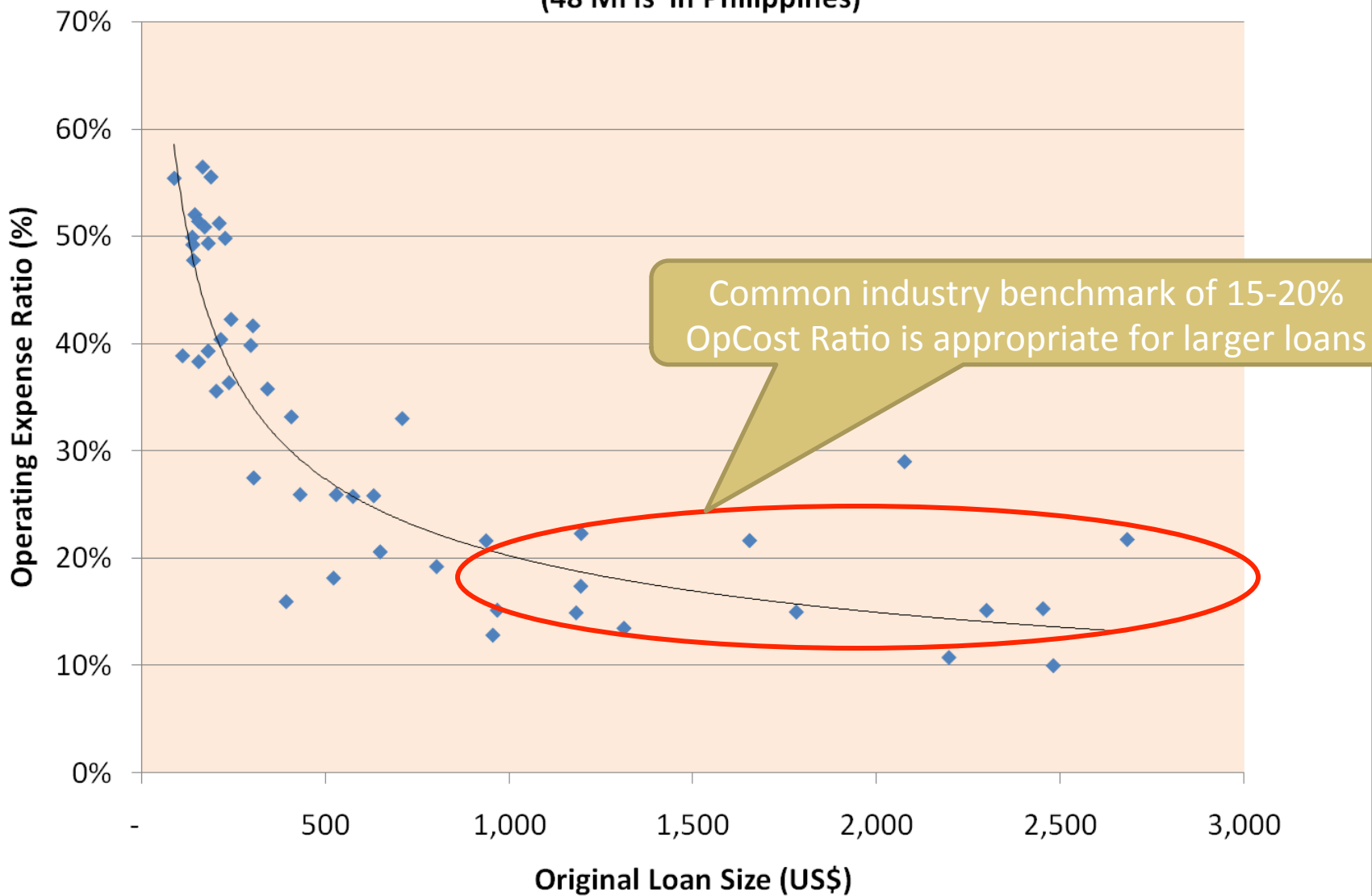
# Comparing “theory” with actual data

- 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

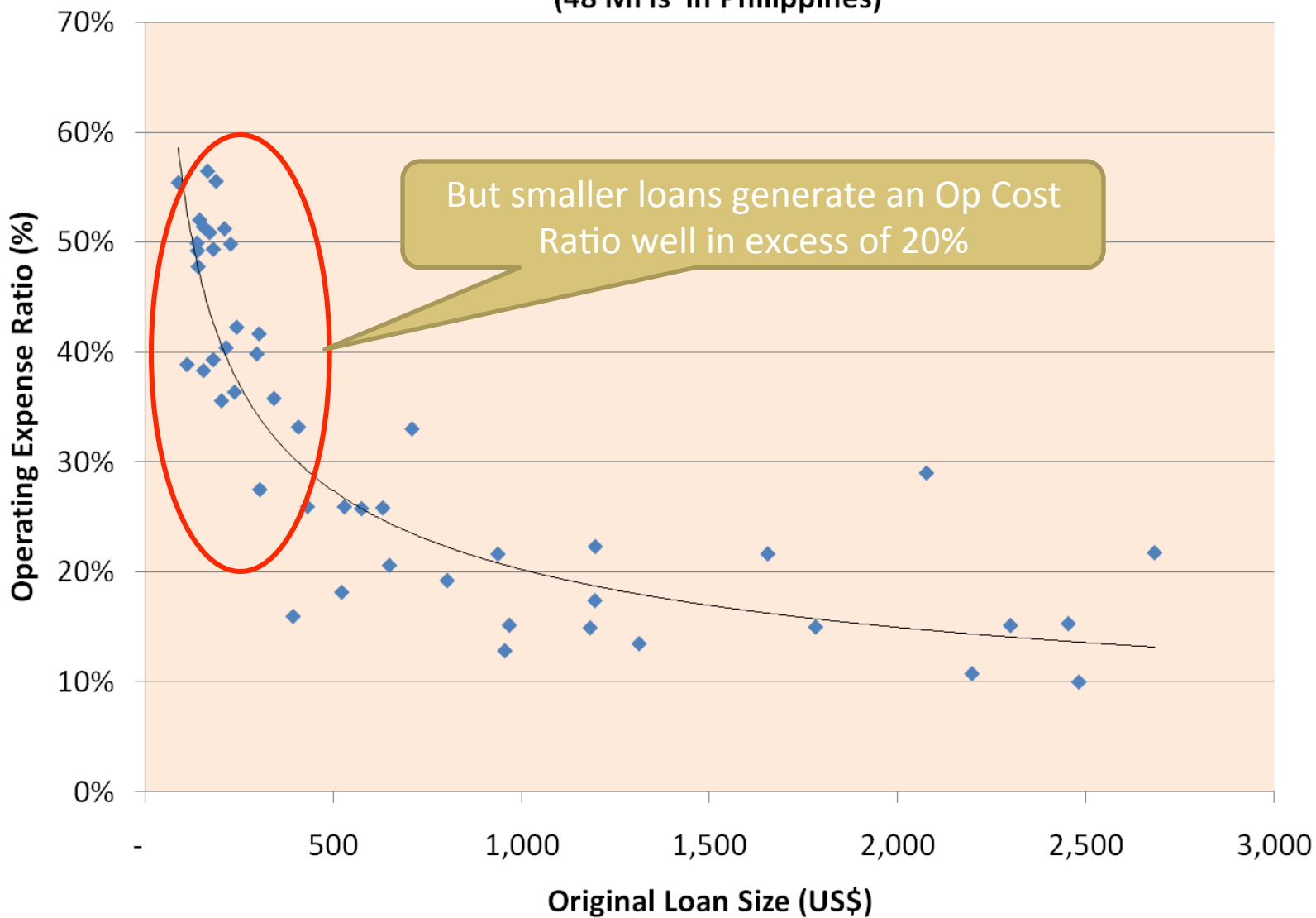
### Loan Size and Op Exp/Port % (48 MFIs in Philippines)



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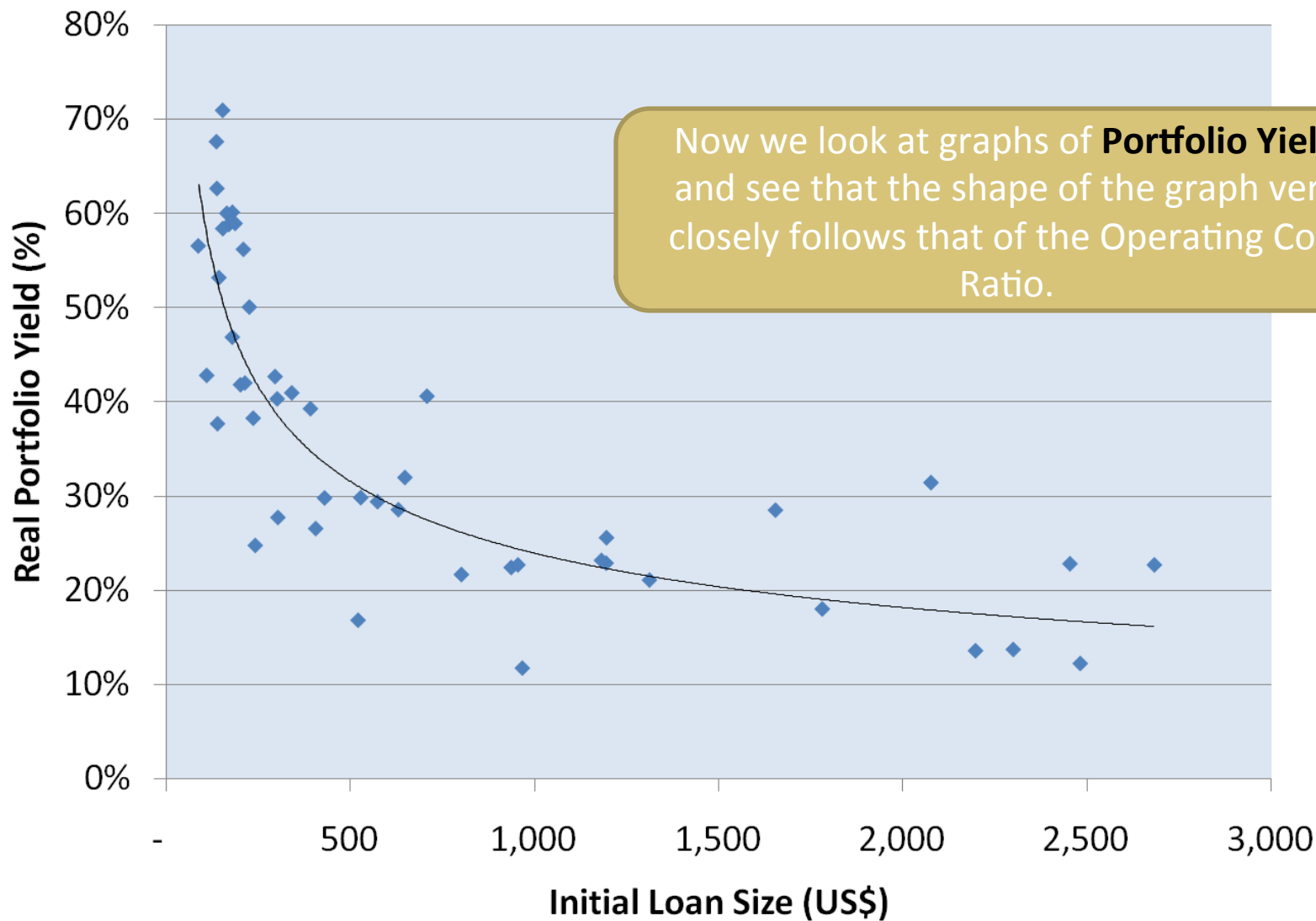


# Pricing for Different Products

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)

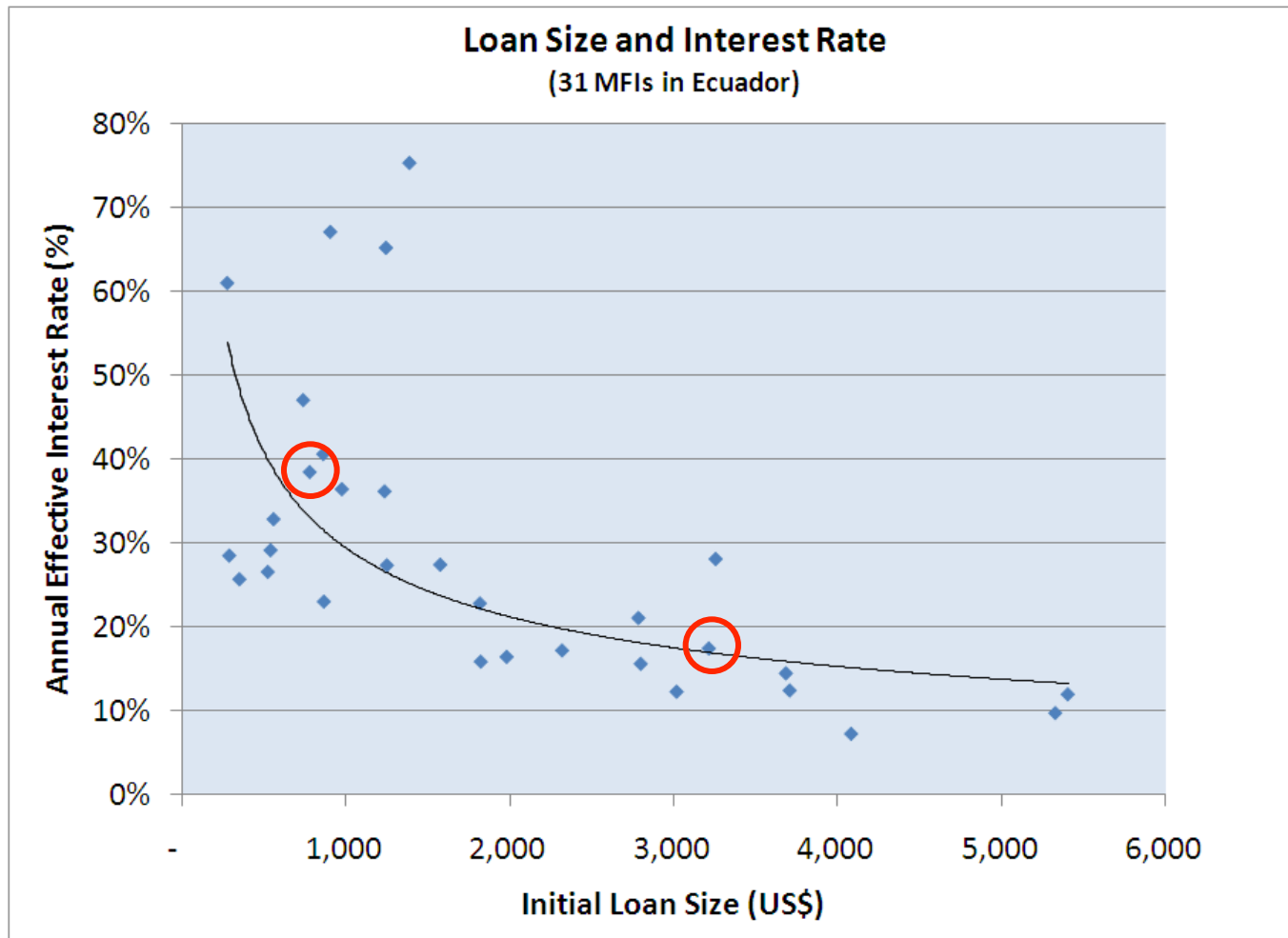


# Four Key Points on Pricing Transparency

1. **Interest rates** vary significantly relative to **loan size**, making transparency difficult
2. We operate in an industry where **non-transparent pricing is common**

# 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?



# 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.

# Example of Loan Pricing

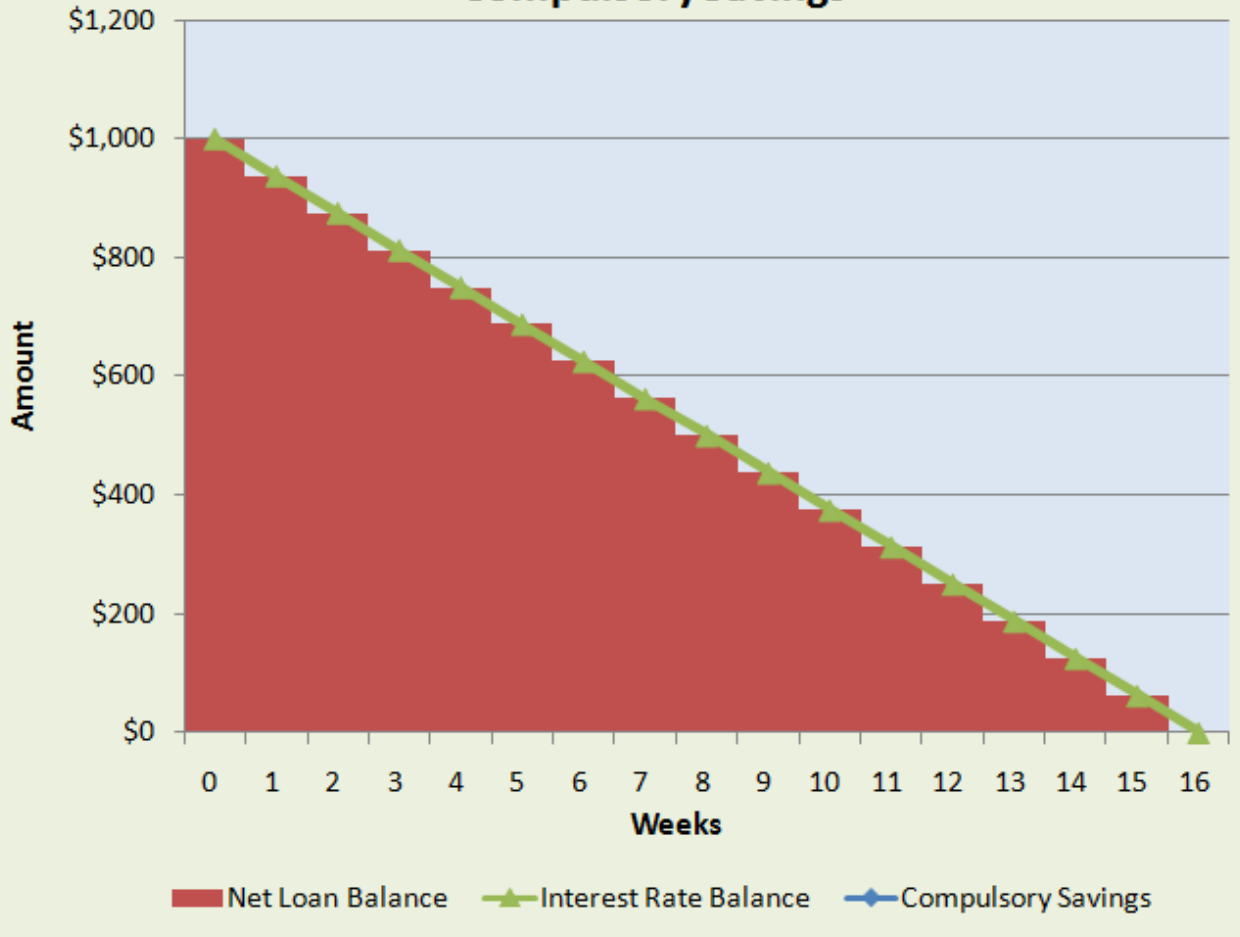
- Interest rate of 3% per month
- Small closing fee of 2%
- Savings account with 15% of loan
- We pay you 5% interest on your savings

What do you think the APR of this loan is?

(we will calculate APR without compounding, i.e, using the US formula, not the EU formula)

Calculation of APR based on Loan Conditions and Pricing

Relation of Net Loan, Interest Method, and Compulsory Savings

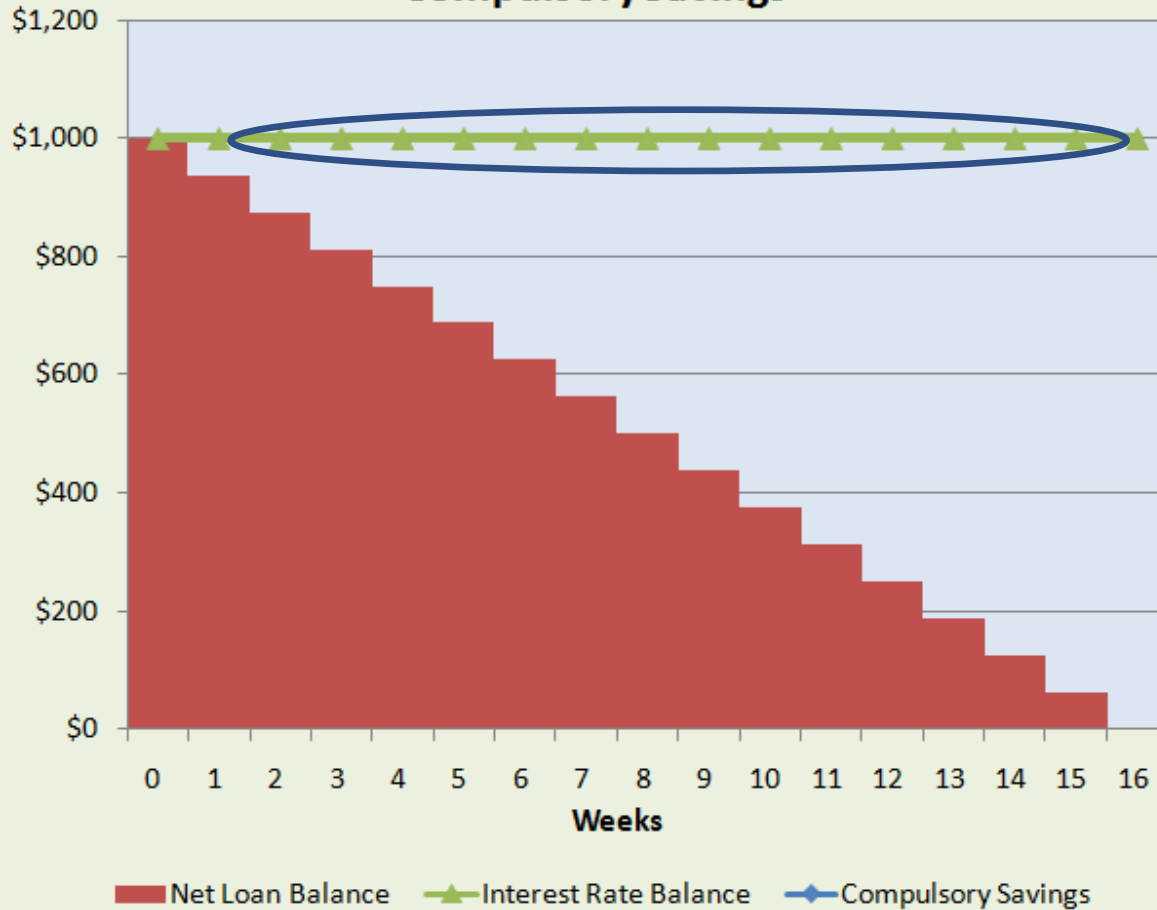


	Nominal	APR
Ann. Interest	36.0%	36.0%
Int. Method	Balance	
Up-Front Fee		36.0%
Savings		36.0%
Savings Int.		

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



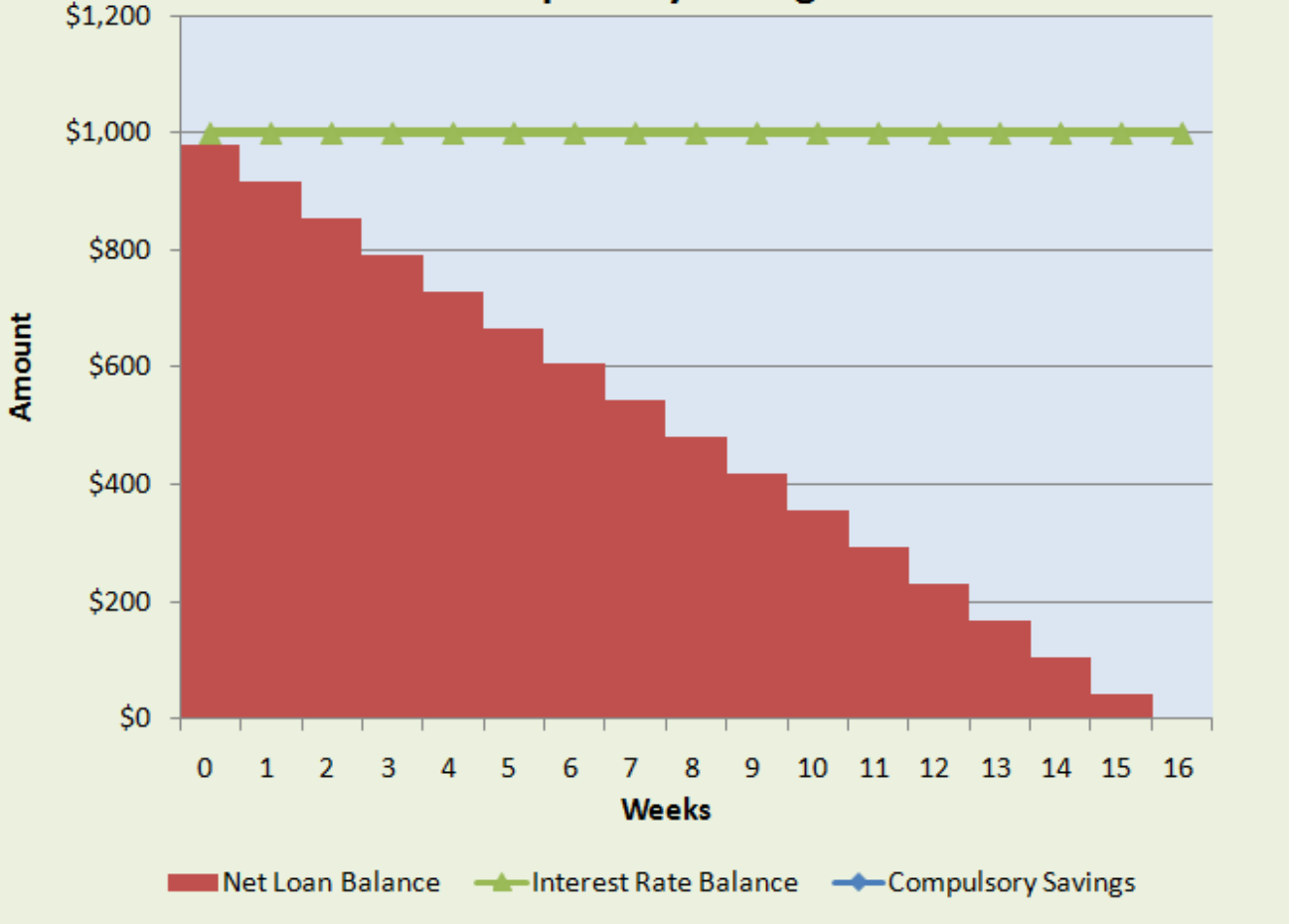
	Nominal	APR
Ann. Interest	36.0%	65.7%
Int. Method	Flat	
Up-Front Fee		65.7%
Savings		65.7%
Savings Int.		

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

Relation of Net Loan, Interest Method, and Compulsory Savings

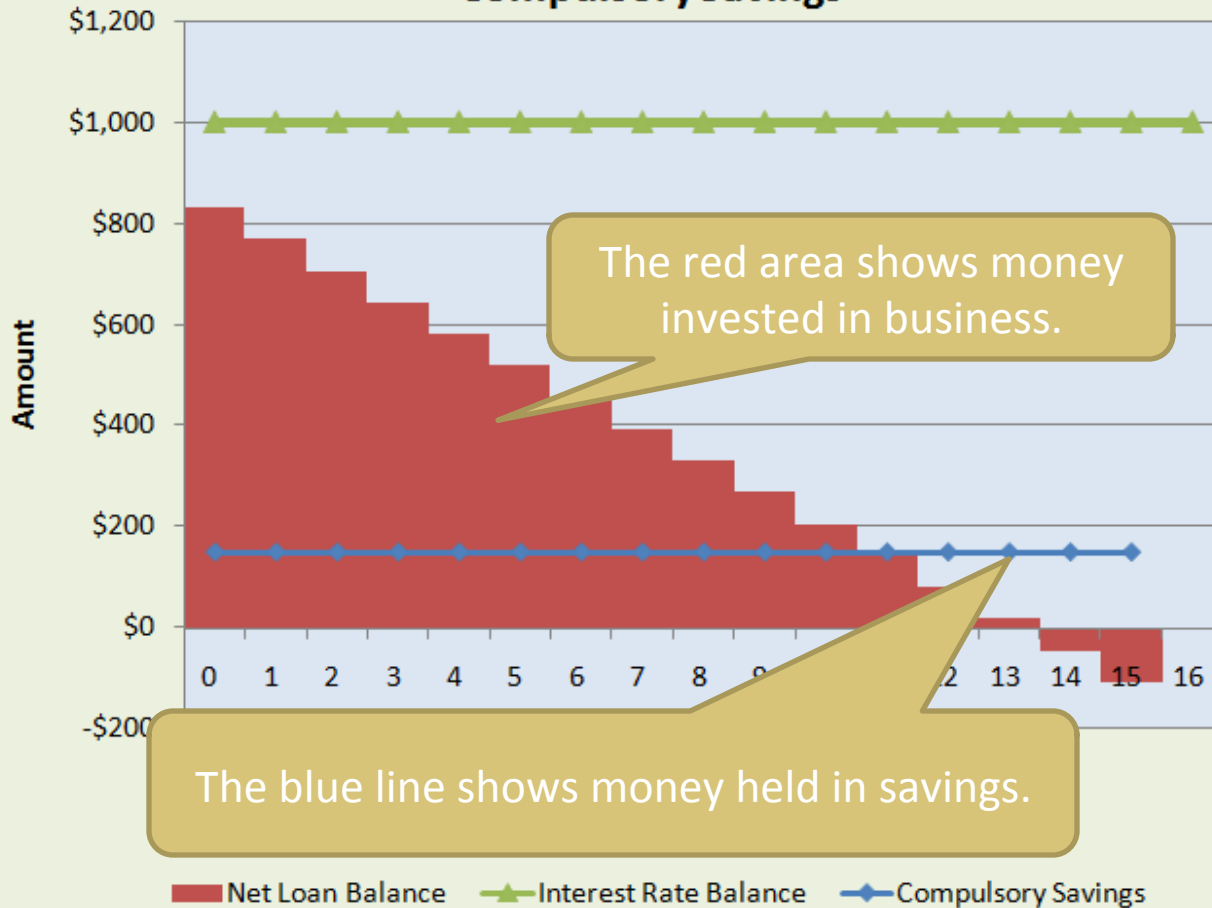


	Nominal	APR
Ann. Interest	36.0%	65.7%
Int. Method	Flat	
Up-Front Fee	2.0%	78.7%
Savings		18.7%
Savings Int.		

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

Relation of Net Loan, Interest Method, and Compulsory Savings

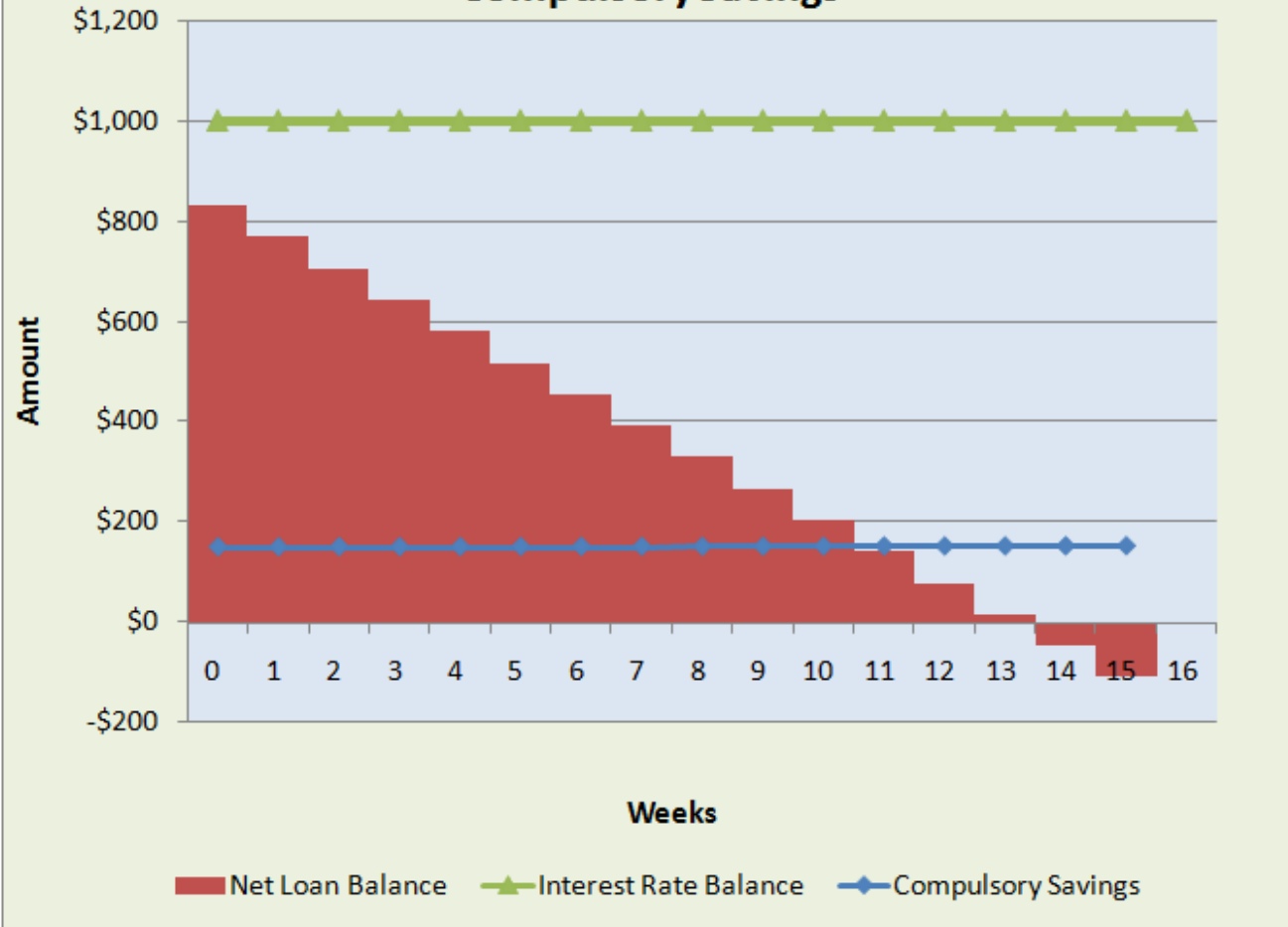


	Nominal	APR
Ann. Interest	36.0%	65.7%
Int. Method	Flat	
Up-Front Fee	2.0%	78.7%
Savings	15.0%	107.0%
Savings Int.		

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

### Relation of Net Loan, Interest Method, and Compulsory Savings

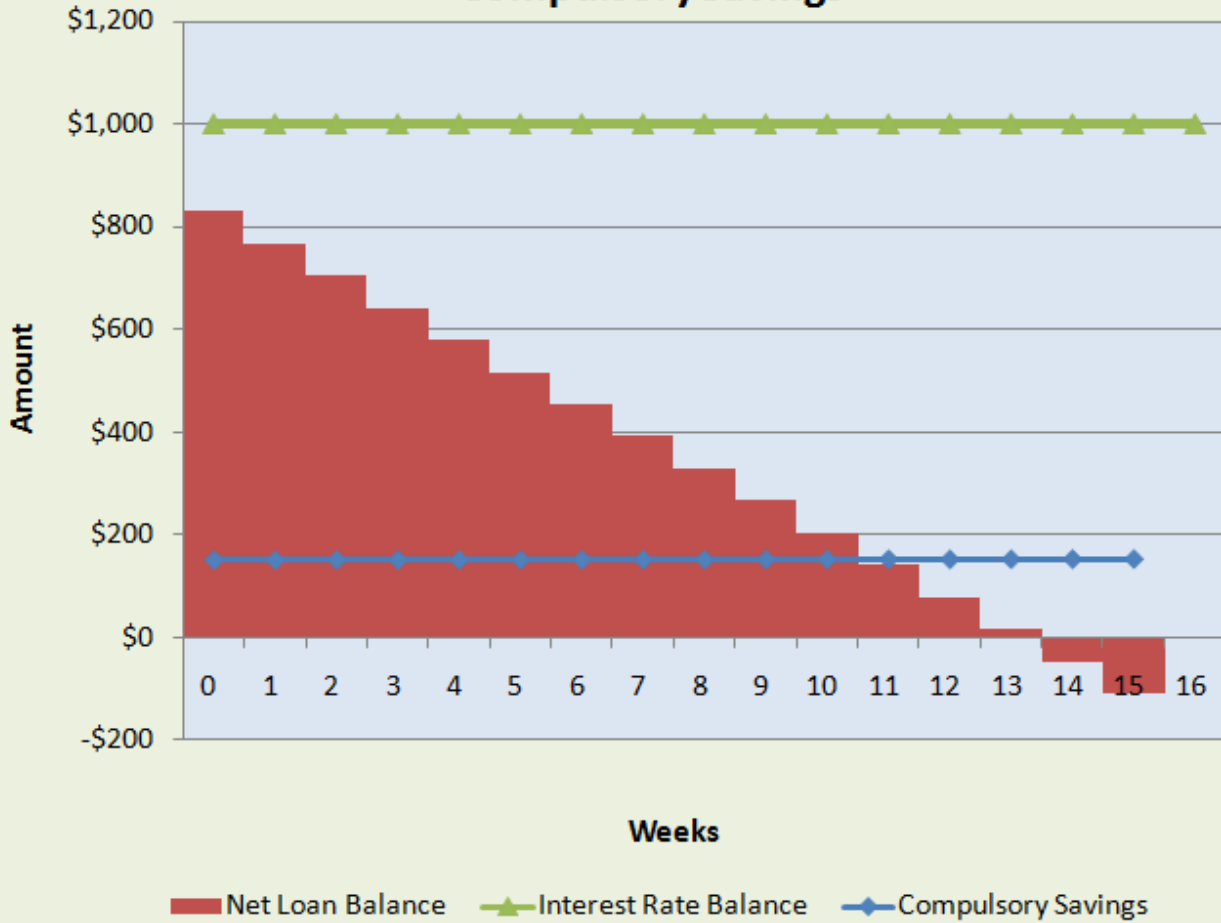


	Nominal	APR
Ann. Interest	36.0%	65.7%
Int. Method	Flat	
Up-Front Fee	2.0%	78.7%
Savings	15.0%	105.5%
Savings Int.	5.0%	

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%	

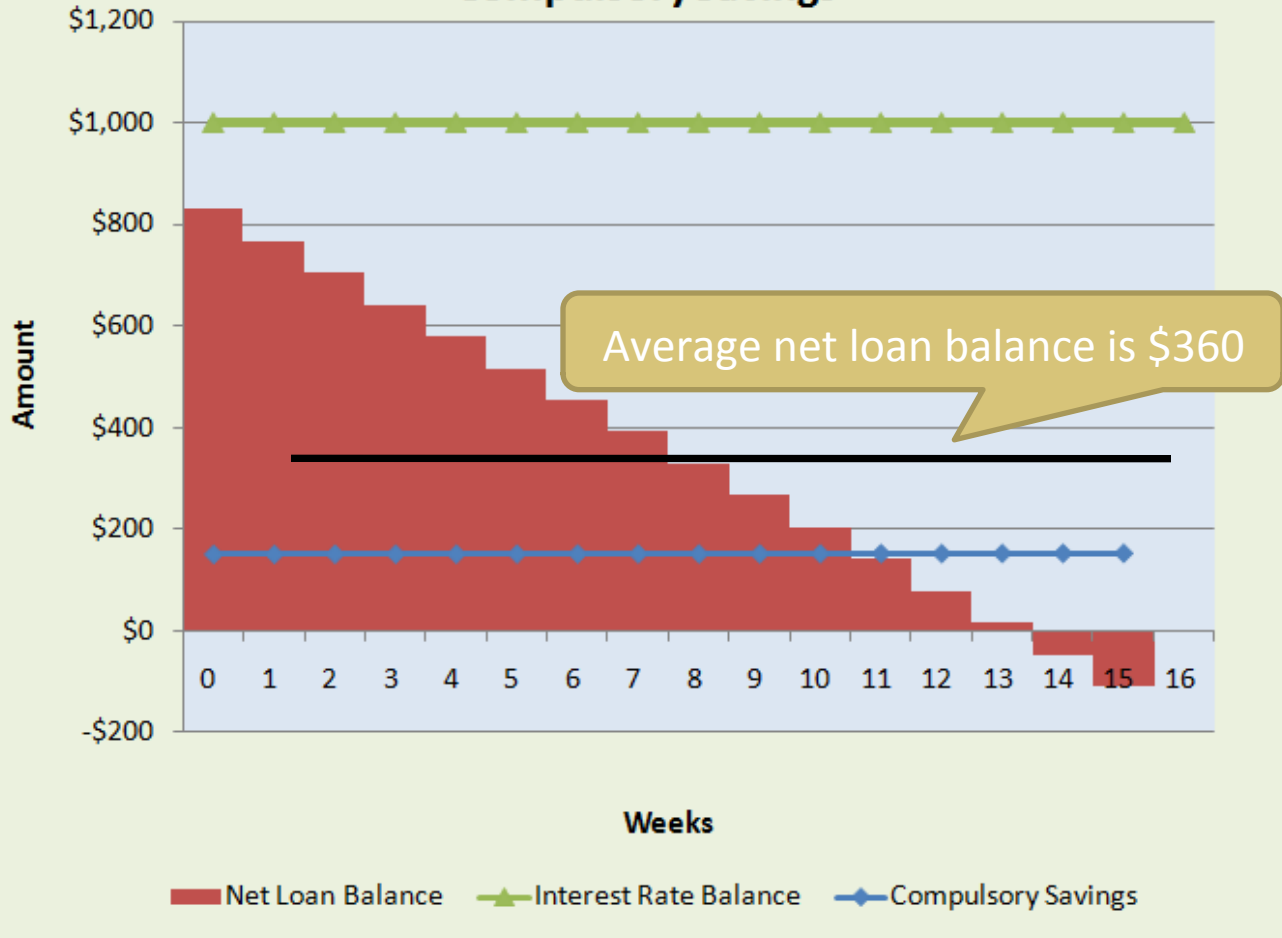
Total Cost	\$131
Annualized	\$425

Avg Balance	\$360
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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

### 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%	

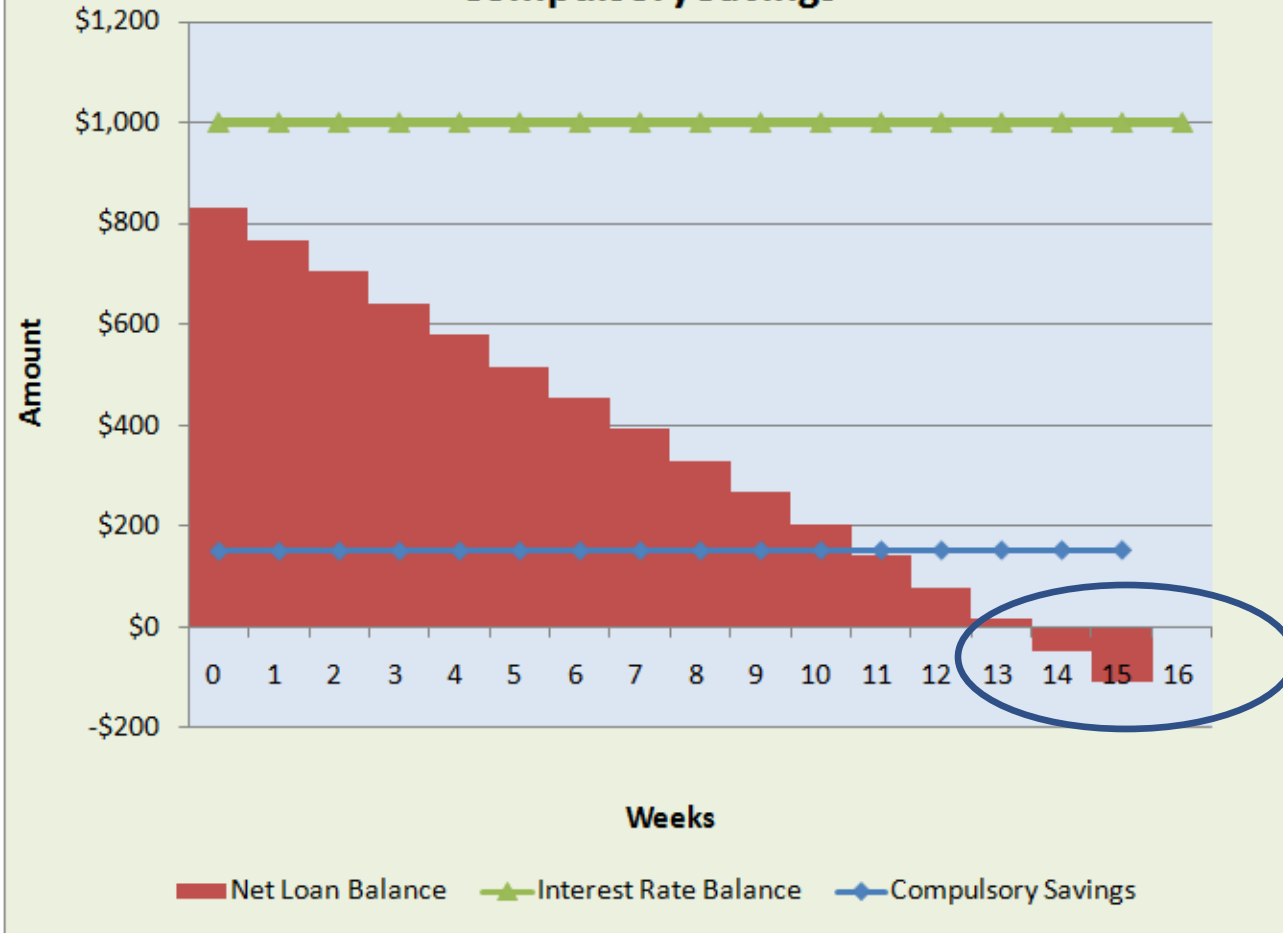
Total Cost	\$131
Annualized	\$425

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

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.

*Loans advertised as 3% per month can have APRs of 79% or even 105%*

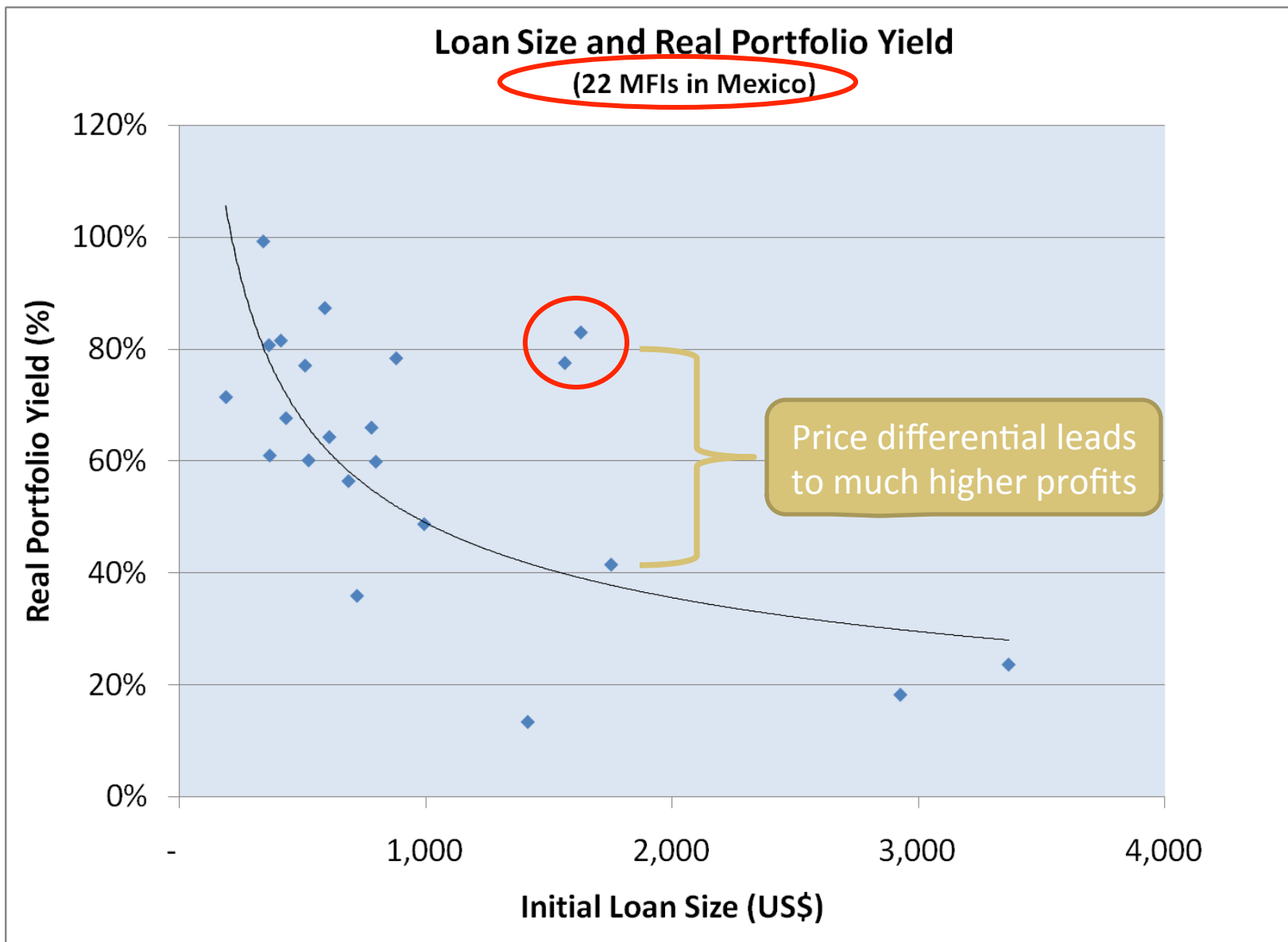
## Why has microfinance practiced and tolerated such universal non-transparency?

- 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
- This is **the major reason for non-transparent pricing** in microfinance



# Four Key Points on Pricing Transparency

1. **Interest rates** vary significantly relative to **loan size**, making transparency difficult
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



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

# 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
  - *Strong* efforts to **attract investor money** into the industry
  - *Weak* **efforts in consumer protection** policies and transparency
- » What are the implications of our past 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

# Four Key Points on Pricing Transparency

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4. **Pricing transparency is essential** to well-functioning markets, promoting efficiency, healthy competition, and better prices for millions of poor people

## Why should the industry advocate pricing transparency?

- The *answer* should be obvious:

**Transparent pricing is the right thing to do!**

The irony is that informed decisions and fair competition require a “**market price**” ....

... and *without transparent pricing there is no market price!*

## How can the industry advocate pricing transparency?

- The *challenge* is how to practice transparency in an environment where non-transparency is the norm...
  - **It is very difficult to be the first or only MFI practicing transparent pricing!**
- **MFTransparency** will create the proper “enabling environment”
  - Enable industry-supported “truth-in-lending”
  - Publish APR-equivalent interest rates all-at-once, country-by-country
  - Educate the public on why interest rates vary by loan size

# Who will monitor MF*Transparency* Info?

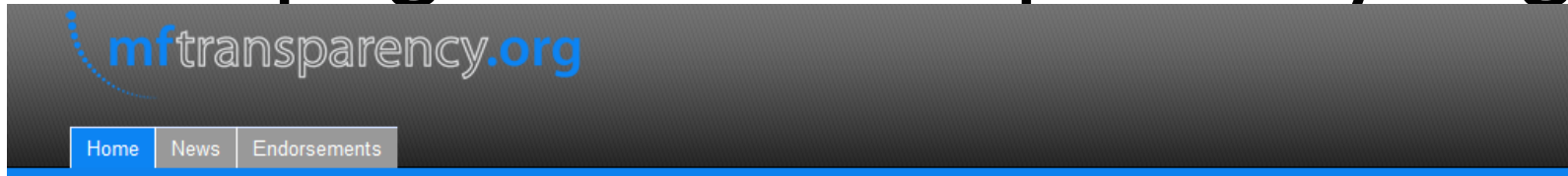
*“MFIs will find the service of MFTransparency very helpful. Investors, donors, policy makers, researchers, and practitioners will immensely benefit from their service.”*

*Muhammad Yunus, Managing Director, Grameen Bank*

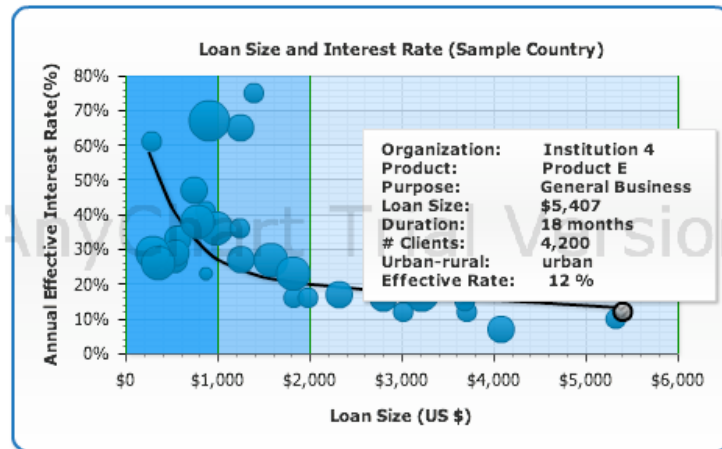
*“MF Transparency aims at giving MFIs information to offer better value to customers. And it will give investors and others the information they need to put pressure on those institutions that may be charging unreasonably high fees or hiding the full cost of their services. We applaud the effort.”*

*Elizabeth Littlefield, CEO, CGAP*

# Homepage of mftransparency.org



**Our Purpose:**  
 MFTransparency is a global initiative for fair and transparent pricing in the Microfinance industry. Our desire is to be the venue for the Microfinance industry to publicly demonstrate its commitment to pricing transparency, integrity and poverty alleviation. Our vision is a Microfinance industry operating with healthy free market conditions where consumers and other stakeholders can make informed decisions.



## Understanding Transparent Pricing: Which Loan do you think looks least expensive?

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

Prices of microloans are frequently stated in a confusing and non-transparent manner. And even when the client can see the total amount to be repaid for the loan, the best choice is often far from obvious.

To address these issues, the proper way to compare costs of loan options is by stating the APR (Annual Percentage Rate). [Click here](#)

## In the News



## Setting Standards for Microfinance

In an effort to head off a potential crisis in the fast-expanding microfinance industry, its leaders are adopting global truth-in-lending

## Events

MF Transparency was introduced at the [Asia-Pacific Regional Microcredit Summit](#) in Bali, Indonesia on July 28, 2008.

### New:

Learn more about MFT by viewing some of the slides shown in Bali:

[Slides from Bali](#) (2MB pdf)

## APR Calculation Tool

Download our Excel tool that will help you calculate and understand interest rates, APRs, and the correlation of operating costs and loan size.

[Download](#) (includes Excel Macros)

## Contact

MicroFinance Transparency  
 325 N West End Ave



# *MF Transparency* Implementation Plan

- Continuing to expand our base of “endorsers”
- Expanding our funding base
- We have hired our full staff to carry out implementation
- Data analysis plans and website designs have been designed and tested
- Continuing to develop educational materials
- 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 in July. 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.”*

*We now have over 170 endorsers*

# 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*