Risk Management – The Implication of Product Pricing

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Transparent Pricing's role in Promoting Responsible Finance and Managing Risk

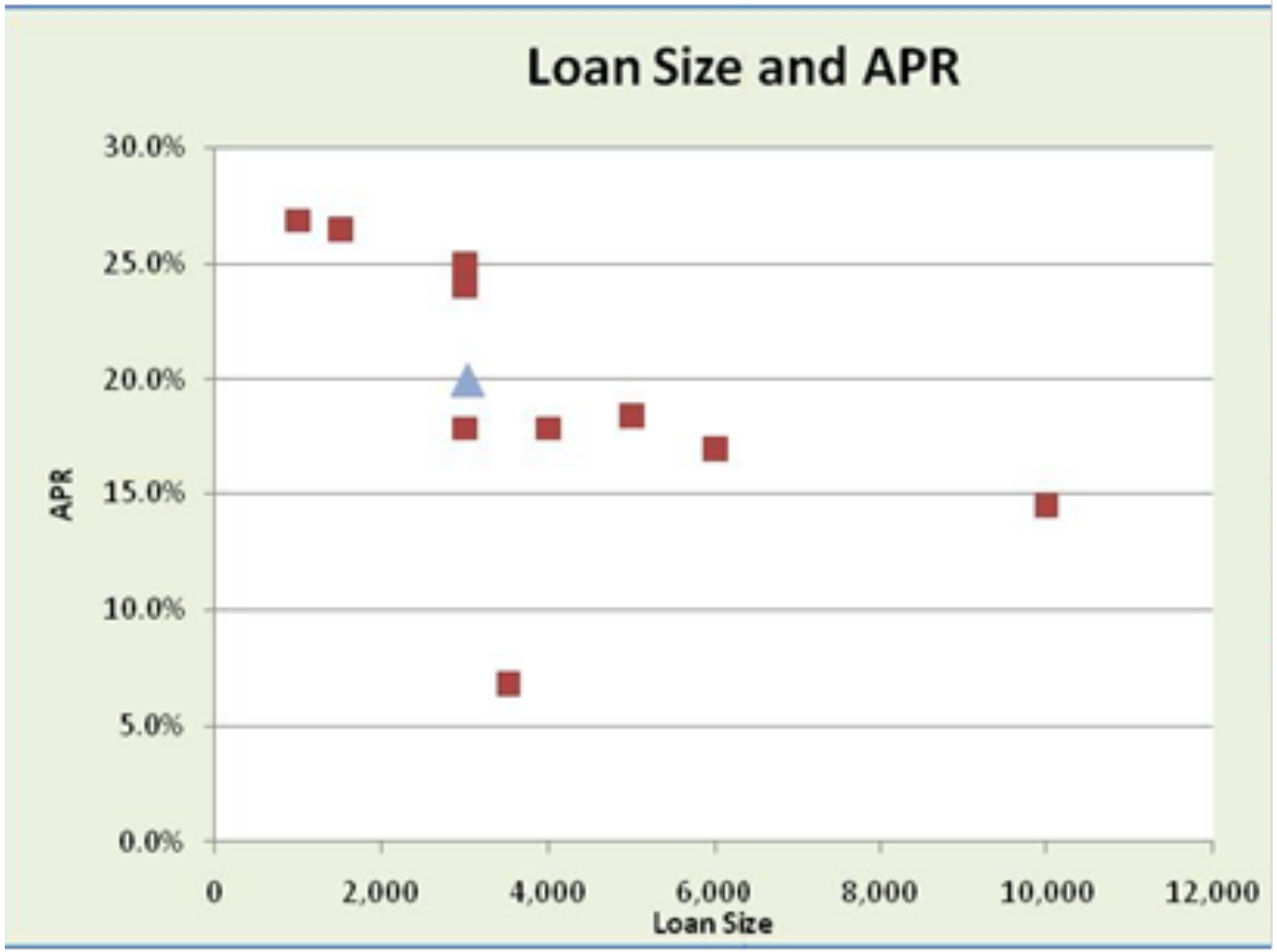
- MFIs are businesses
- MFIs sell products
- Products have prices
- Micro-credit prices are bewilderingly confusing
- If buyers don't know true prices, the market doesn't work
- If buyers get abused, microfinance becomes a tarnished industry
- Transparent pricing protects the poor and protects the microfinance industry

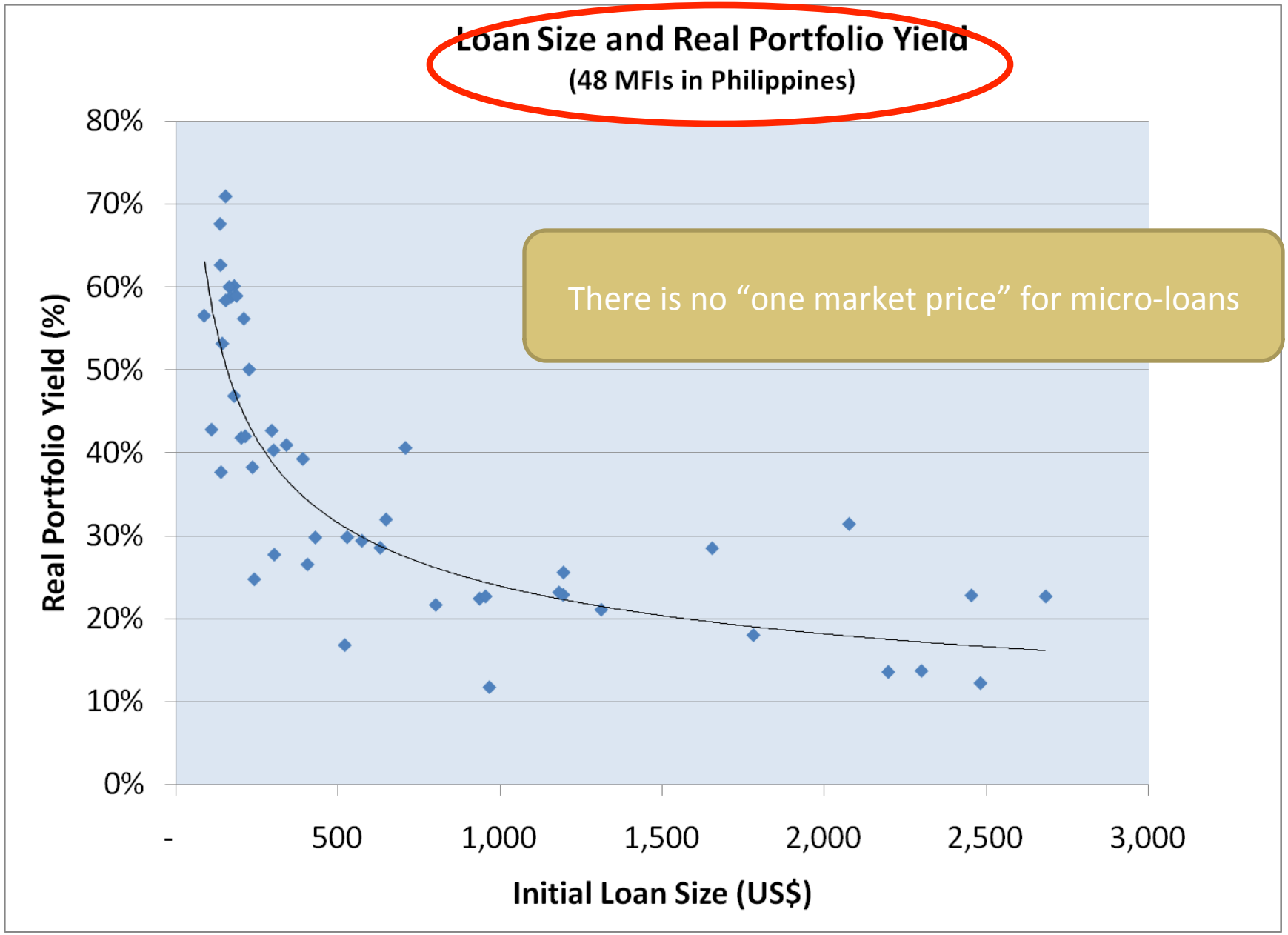
Measuring Risk Through Financial Analysis

- We have the standard financial ratios through sources such as the MIX:
  - Operating Cost Ratio
  - Portfolio at Risk
  - Capital Adequacy
  - ROA/ROE
- What about product price?
  - We sometimes have access to Portfolio Yield
  - Is that sufficient?

Avg Portfolio Yield Doesn't tell Everything

Figure 6: Product APR and Portfolio Yield for "Partner"




Loan Size and Real Portfolio Yield
(48 MFIs in Philippines)
There is no “one market price” for micro-loans
Real Portfolio Yield (%)
80%
70%
60%
50%
40%
30%
20%
10%
0%
-
500
1,000
1,500
2,000
2,500
3,000
Initial Loan Size (US$)

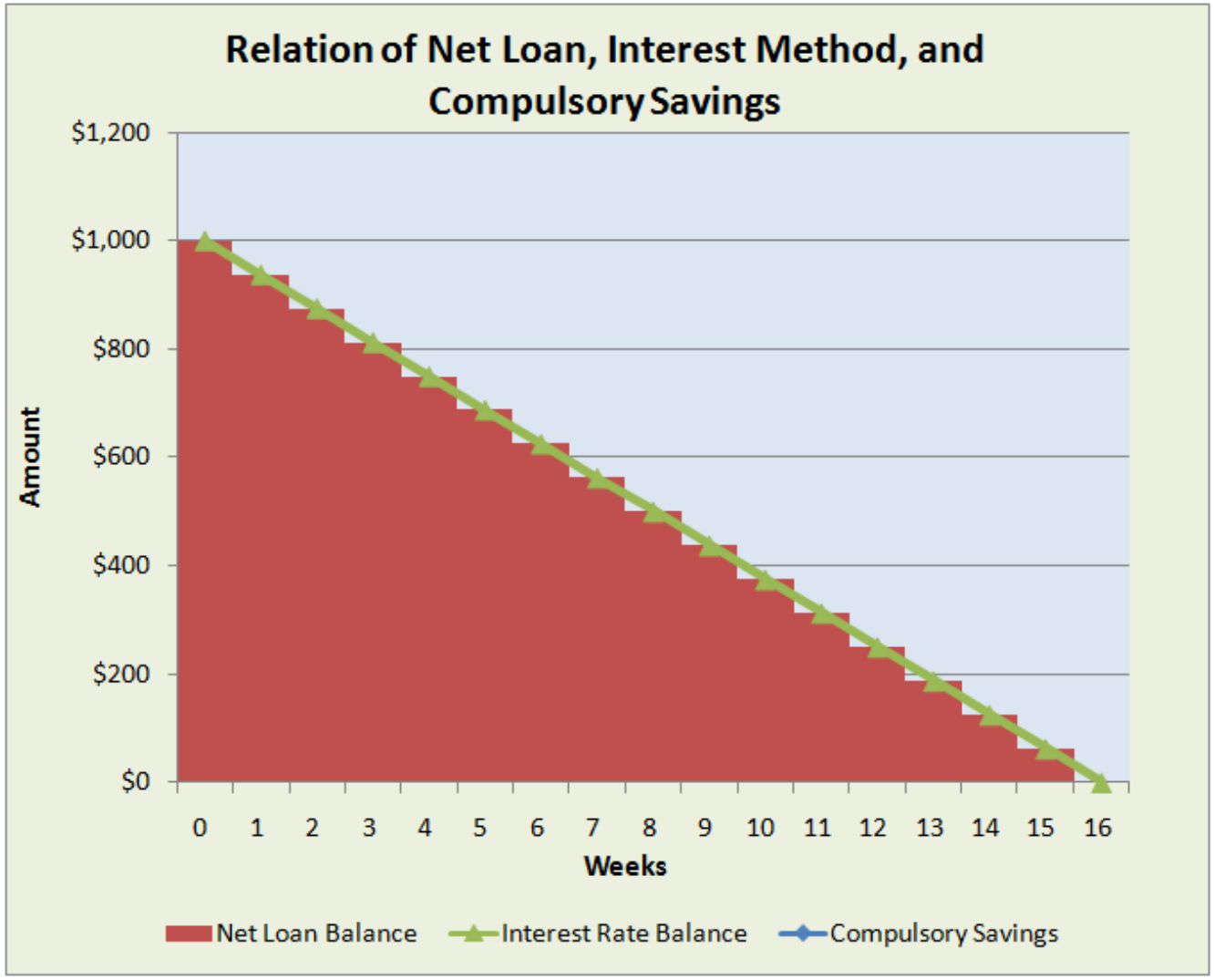
Example of Loan Pricing

- 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)

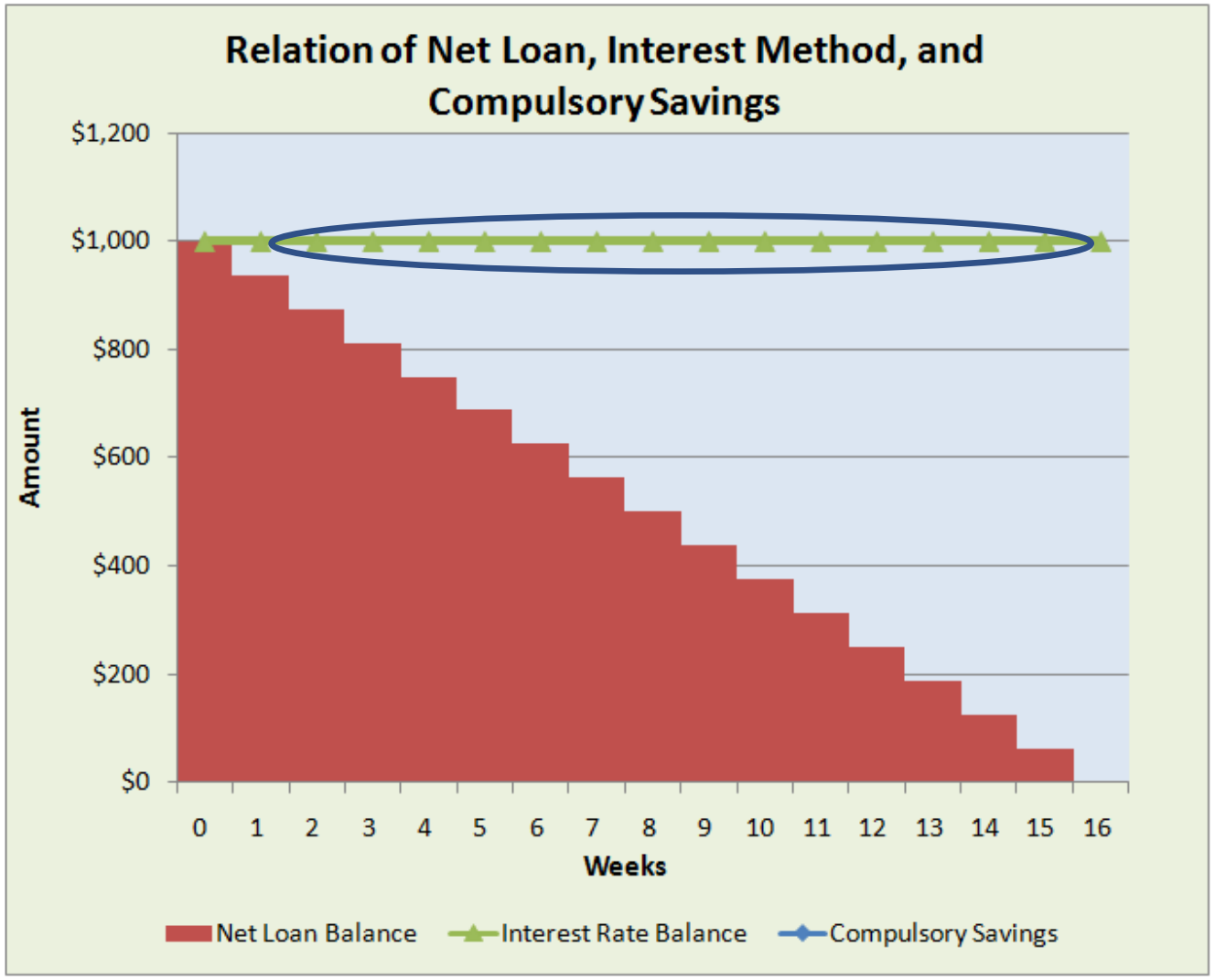
Calculation of APR based on Loan Conditions and Pricing



	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 fees.

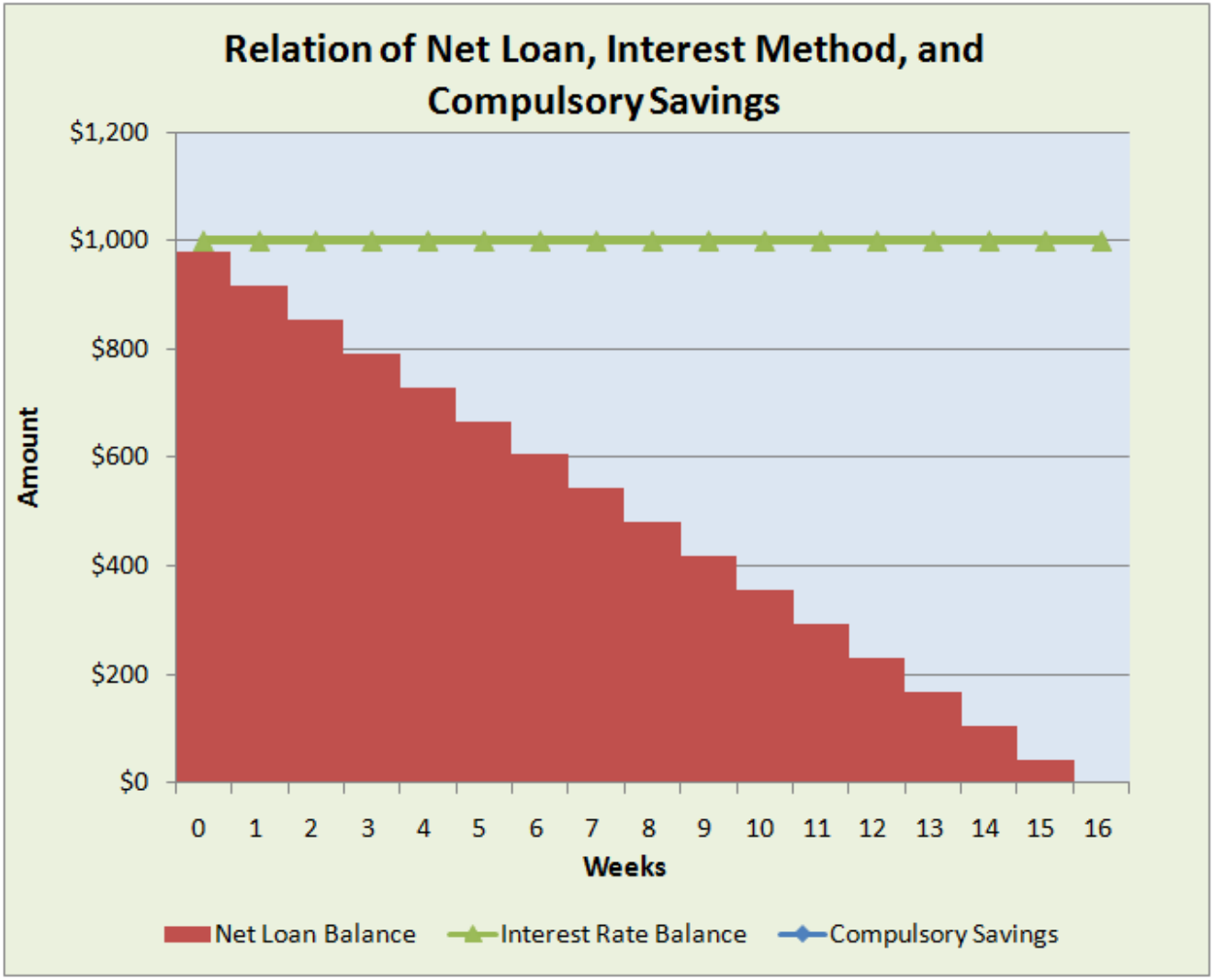
Calculation of APR based on Loan Conditions and Pricing



	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



	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.

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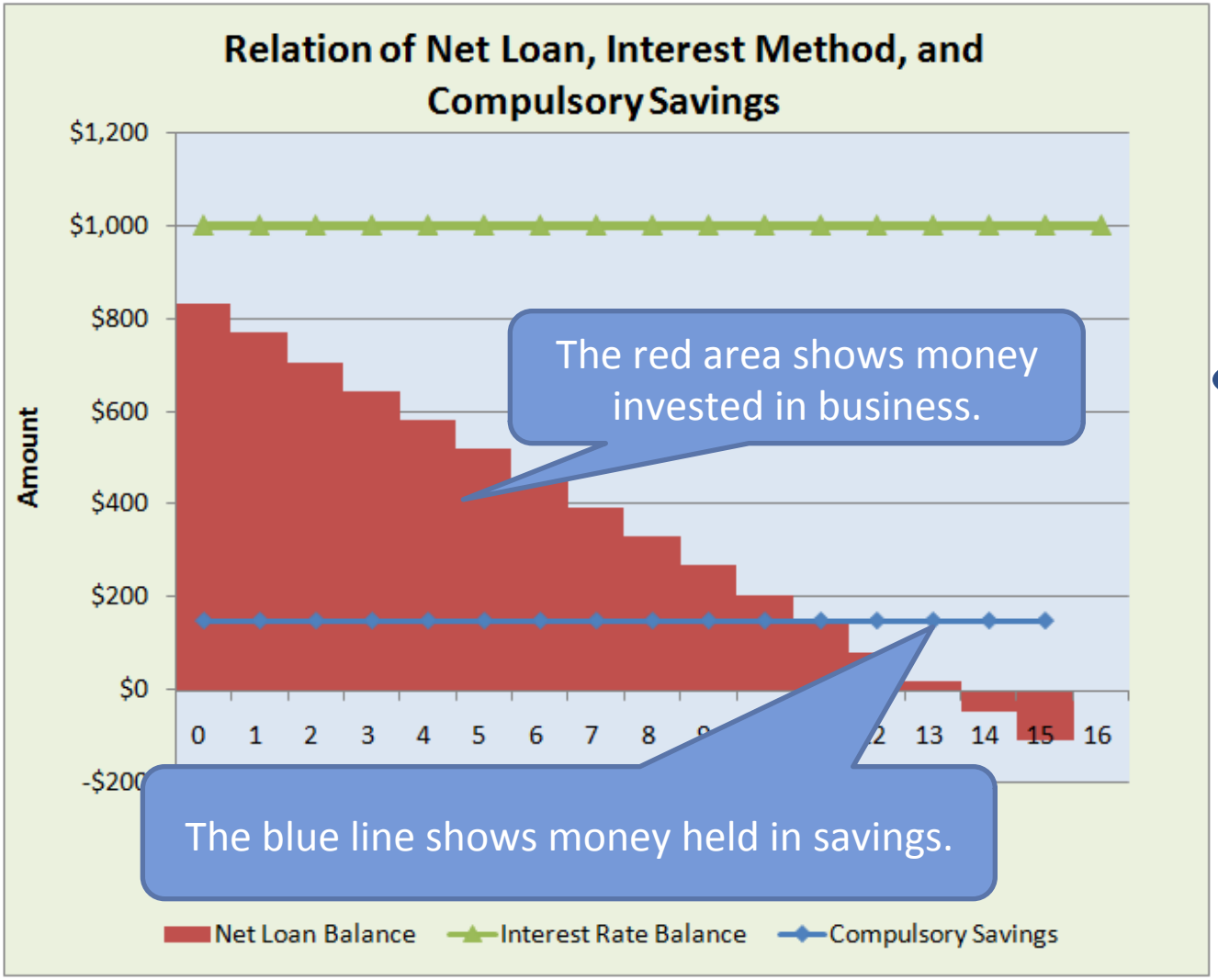
Calculation of APR based on Loan Conditions and Pricing



	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%.

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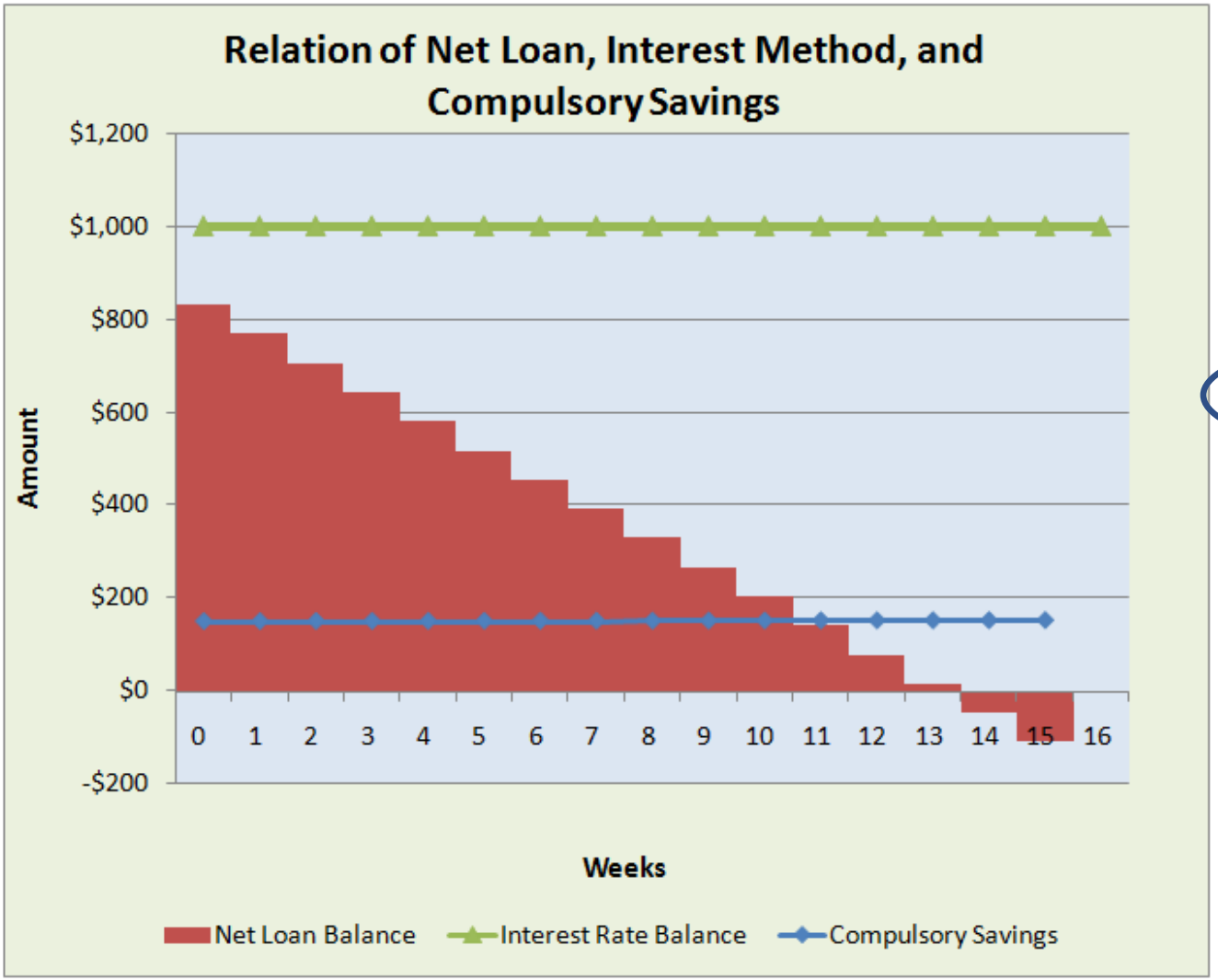
Calculation of APR based on Loan Conditions and Pricing



	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%.

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You need pricing information to make sound decisions

- You can demand the necessary information from your prospective clients to calculate the APR
- Don't just ask what they charge – get the necessary information to calculate it yourself
  - Many don't really know what their true price is
  - The figures they tell you can be extremely misleading
  - Don't trust portfolio yield
- The procedures are well-documented and objective
- Organizations such as Planet Rating and MFTransparency are already doing this

Transparent Pricing's role in Risk Management

- Financial Ratios are important, but we don't have true price
  - Portfolio yield is not enough
- Micro-loans are sometimes 2 to 3 times more expensive than advertised
- Product prices influence risk
  - **Competition:** Are your clients' products positioned competitively?
  - **Repayment:** How do prices affect ability to repay?
  - **Public Image:** Transparency and Corp Social Responsibility

Product prices and Risk Management

- **Competition:** Are your clients' products positioned competitively?
  - They may lose their client base
- **Repayment:** How do prices affect ability to repay?
  - Are prices much higher than believed? This can result in repayment problems with a significant portion of the portfolio
  - Parallels with sub-prime financial crisis
- **Public Image:** Transparency and Corp Social Responsibility
  - More negative press than positive
  - How big is the gap between quoted and true price?
  - What risk that your client will be tied to negative publicity?

The Good News in October 2006

BusinessWeek

HOME INVESTING COMPANIES TECH INNOVATION MANAGING SMALL BIZ

DECEMBER 26, 2005

VOICES OF INNOVATION

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 t Friday. On its Web site, the Norwegian Nobel Committee s Yunus, 65, and the bank 'for their efforts to create econom below."*

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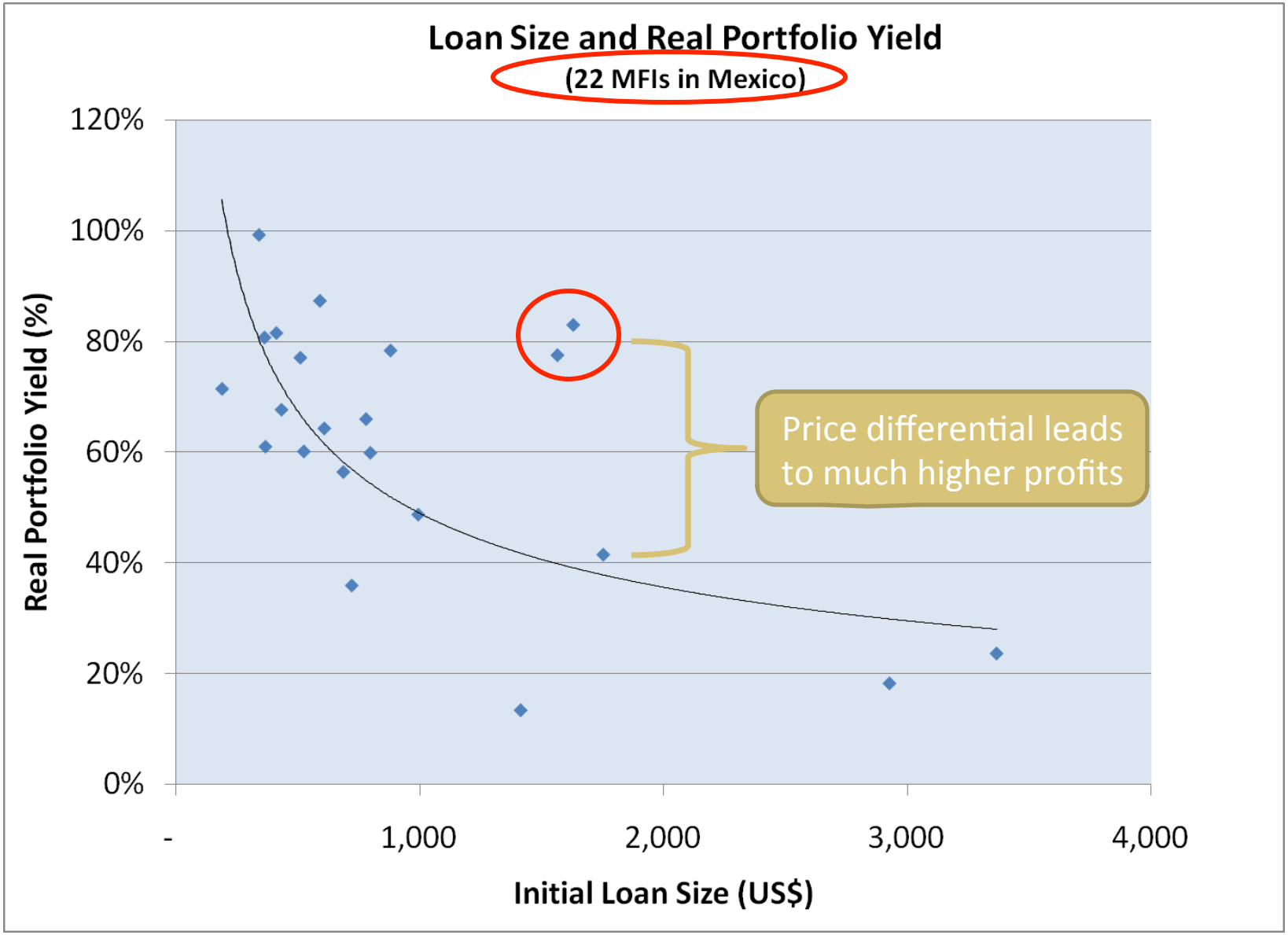
The Boston Globe

Billions of dollars and a Nobel Prize later, it looks like 'microlending' doesn't actually do much to fight poverty



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

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