

IS TRANSPARENCY ENOUGH?

WHAT IS FAIR AND ETHICAL WHEN IT COMES TO PRICES IN
MICROFINANCE?

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SECTION 1. WHAT PRICE WE CHARGE THE POOR – AN ISSUE THAT REACHES THE CORE OF MICROFINANCE

INTRODUCTION

The very first thing I must say is: **I did not pick the title for this paper!** It was assigned to me by the Micro Credit Summit. I would not have dared a title so bold and subjective – and important. I have certainly talked openly about transparent prices, but I have only quietly discussed the need for us to dialogue on the issues of fairness and ethics. Now with this paper I must put some of my thoughts on these topics into the public realm. I must also state that these are my personal views. I am not speaking on behalf of MicroFinance Transparency.

The Summit requested that I complete this paper months before the event. I insisted I could not. I needed time away from my daily work responsibilities to delve more thoroughly into the concepts of fairness and ethics. I decided to coincide writing the paper with an already-planned time where I was to be reflecting on those very issues – as I write this paper, I am riding my bicycle from Rome toward Spain. My first part of 2,500 kilometer route takes me through key areas of Italy where the topics of fair and ethical financial services for the poor were explored nearly 1,000 years ago. It has humbly put the 25 years I've personally spent in microfinance into a much deeper and more complex perspective.

Many of those thoughts permeate this paper, together with exploration of loan pricing and loan delivery cost data. It's been a difficult task to blend together a *new* way of looking at financial ratios with an *old* way of looking at ethics and fairness and see if the two approaches can find any common ground. I confess that I'm still finding my way on this, and I look forward to your ideas and comments as we continue down this path together.

WHAT MAKES MICROFINANCE UNIQUE?

Here is a really important question for us to discuss, and for us to articulate to those outside of our industry: How much has microfinance done that is truly unique? What makes us different from what was previously done through the ages, since coins were first established as a medium of exchange? And how can we maintain those unique aspects and avoid slipping into the well-worn paths that are apparent when we examine the history of lending to the poor?

Have loans to the poor always been provided at fair and ethical prices? Certainly not. So are we not *obligated* to investigate if *our* prices are fair and ethical? Without definition, we have no means to distinguish between what we do in the industry and what went on before us.

Compassionate or Commercial?

First, I must say something about terminology. The issues we are discussing form a continuum I will describe later. I am going to use two terms to indicate the ends of the continuum – **compassionate** will mean

institutional motives are driven primarily by good will and charity, while **commercial** will mean motives are driven primarily by textbook business principles of profit maximization behavior (while not breaking any laws). Double-bottom line organizations in our industry argue they do a balanced degree of both at once, and we will explore those goals and the challenges of maintaining those goals.

As we will see in this paper, through history there have always been purely commercial sources for the poor, most of which have been scorned by society as exploitative. There has also been an array of highly compassionate sources for the poor that are generally not part of the “commercial business” world. There have been few historical examples that carefully balance the line between compassionate and commercial, and the microfinance industry often states that this balance is our goal. If we are successful, it is what sets us apart from much lending of the past thousand years, but I believe that the careful balance is a difficult goal to attain and an even more difficult goal to maintain.

Responsible Commercialization

Fundamental to this discussion, we will investigate how most of us accept the argument that microfinance must become a commercial activity. We will then examine the implications of commercialization. Making loans to the poor has *always* been a commercial activity, but was one generally shunned by the broader society. If we have decided to transition into commercialization, how do we do so without becoming indistinguishable from modern day usurers? We need to *define and monitor* the distinctions between microfinance and moneylending in order to *maintain* the distinctions between microfinance and moneylending.

Without dialogue and setting standards, pure commercialization of those at the “Bottom of the Pyramid” can likely do what commercialization of the Bottom of the Pyramid has always done – those with money and power will take advantage of the situation of the poor, and the poor remain poor, or end up even poorer.

In the past fifteen years, we have moved rapidly toward commercialization without taking the necessary and challenging step of articulating a definition of responsible commercialization. We need clear definitions, we need clear practices for which we can be held accountable for maintaining, we need lines that distinguish microfinance from moneylending, we need better understanding of the issues and realities of microfinance, and we need transparency rather than opacity. Opacity is convenient for profit-maximizing businesses. Opacity allows the powerful to wield yet more power. Transparency burns off the fog and puts an MFI in a glass house. Let the world see what you are doing, and why, and your behaviors and decisions change accordingly.

A PROPOSED PROCESS FOR DISCERNING FAIRNESS AND ETHICS IN PRICING

Our Limited Understanding of Pricing

The time is long overdue for us to better understand of the pricing we charge the poor and to advance on our positions on two issues: 1) How should we set those prices, and 2) How should we communicate those prices.

It's rather obvious – since coins were invented, the poor have *always* had access to credit, but that access was almost universally seen as at exorbitant prices and unfair conditions. Microfinance was born to provide credit with respect for the client and delivered at a “fairer price.” That is a clear, logical and compassionate motive, and it appealed to the world, as evidenced by the way microfinance has rapidly grown and become so popular. However, after decades of selling loans to the poor, we ourselves still don't adequately understand or communicate true prices. It is our obligation to fix this. There is no excuse for this to continue. And in the past two years we have made dramatic progress on understanding our true prices and we now have substantive dialogue on issues of pricing. We have increased our knowledge to now move to the next stage of discussing: Should we define fair and ethical prices, or should we simply “let the market decide”?

The Change in Perspective Brought About by Profits and Practice

The microfinance industry went through a lengthy period with a casual and uninformed position on pricing. At the time, no MFIs were generating significant profits. Then, when profits became noticed, new questions started coming from the public, the press, the funders, and governments:

- When making such high profits off of the poor, what price are you charging for the loans?
- Regardless of profit, what price *should* the poor pay for loans?
- How much profit should a “responsible business” be making from of the poor?
- Now that microfinance has become a very profitable business for some, what distinguishes microfinance from moneylending?

We had gone through a decade of collecting and posting transparent financial data from a large number of MFIs, reporting most significant financial indices except the price (or portfolio yield). The industry was well-regarded for both rigor on financial analysis and for openness with that financial information, and the absence of pricing data was generally overlooked.

As the questions about profit and other arguably irresponsible business practices came, we have made serious efforts at addressing issues of transparent pricing, promoting general consumer protection, measuring our social performance, and more recently with defining and committing to responsible practice. It is in this latest phase that we are moving beyond just calculating numbers. We are now in a position where we necessarily must make difficult and arguably subjective judgments as we analyze those numbers, incorporating subjective values such as fairness and advocating that for microfinance, ethical practice goes beyond just “not breaking any laws.”

A Three-Step Process

This paper comes as these questions surround us, but a single paper, written by a single person, cannot conclusively define something so difficult. However, such a paper can potentially provide a significant step in the process of us working together to build consensus on this challenging and important issue.

This paper is the first in a planned series of three papers that will examine the challenges of maintaining the difficult balance of being sustainable institutions that responsibly provide financial products to the poor. The three steps are designed to look at three intertwined components of pricing – delivery costs of the MFI, the prices that MFIs currently charge, and investigation of levels of prices that clients can afford:

Step 1: Delivery Costs -- This first paper will provide the general context and then focus primarily on the challenges of loan delivery costs for the smallest of loans. Because of the very significant cost curve, sustainable MFIs need charge higher and higher prices in order to be sustainable for their smallest loan products. It will then examine some issues and implications of our views on sustainability. It will close with a position on the link between price setting and profit maximization.

Step 2: Product-level Pricing – The second paper will examine pricing in detail, using data collected by *MFTransparency* that allows detailed analysis of prices by loan size, loan term, loan purpose, gender, urban/rural issues, age and scale of institution, and institutional form. What products are priced above delivery cost? Do MFIs cross-subsidize their products? Do MFIs have some loss-leader products? Aggregate portfolio yield data does not give us these answers, but *MFTransparency's* data can help get us some indications.

Step 3: Client benefit – The final paper will explore the ability of clients to pay the range of prices charged in microfinance and estimate at what point the majority still benefit from those loans. The final paper will also then pull together the three points investigated in the three papers – 1) prices that MFIs *need* to charge in order to be sustainable, 2) prices that MFIs actually *do* charge, and 3) prices that are demonstrated to be generally positive for the clients to pay. Together, these three inter-related points can help us to define fair and ethical pricing.

Synopsis of this First Paper

The sections of this paper address the following areas:

Section 1: What Price we Charge the Poor – An Issue that Reaches the Core of Microfinance proposes that the microfinance industry should take on the important challenge of broadly defining ethical and responsible practice, and within that the issue of fair and ethical pricing. There is no *legal* obligation for us to do so, but a large number of us believe there is a *moral* obligation that we do so, and the sense of the general public and most governments seems strongly on the side of expecting moral behavior from businesses involved in what has through history been called usury. It defines a process for moving forward in this definition.

Section 2: The Need for Transparent Pricing presents some foundational issues about how to define a transparent financial price, why non-transparency inhibits a market from functioning properly, and how regulators of formal finance help to correct the problem with Truth-in-Lending legislation.

Section 3: The Price Curve Resulting from the Cost Curve provides new insight into how product delivery costs and current microcredit prices behave very differently than commonly assumed. The material gives a

theoretical case for the cost curve and the price curve and then examines data from numerous MFIs and countries.

Section 4: A New Benchmark for Operating Costs is material presented for the first time in this paper. It examines and compares product delivery cost data across countries and proposes a new generalized benchmark for assessing approximate efficiency levels of MFIs.

Section 5: The Bind of Prices and Profits – Underlying Assumptions that Drive Current Practice then applies this deeper understanding of the costs of delivering microcredit to the industry’s standards on MFIs reaching financial sustainability. Seeing the challenges of delivering different kinds of loan products through the new lenses constructed in the first part of this paper will likely lead to more interesting and complex discussions of sustainability than we have had in the past.

Section 6: Advancing on our Determination of Fair and Ethical Pricing then goes behind the concept of sustainability and addresses the issue of profits and degree of profits. Our profits are a result of the prices we set. There is a direct correlation between our “fair and ethical” prices and the amount of profit we make from those at the Bottom of the Economic Pyramid. Thus, we cannot get to a definition of fair pricing without examining also the issue of profits. Those MFIs who make high profits have intentionally *chosen* to make high profits, and they do so through the prices they set on their products.

SECTION 2. THE NEED FOR TRANSPARENT PRICING

Over the past three years, the industry has made significant progress in agreeing on the importance of transparent pricing, but there is still ambiguity over how to define transparent pricing. This section addresses the importance of using an approach that calculates “unit price” and gives a short background on Truth-in-Lending legislation used in many countries.

HOW SHOULD WE DEFINE TRANSPARENT PRICES?

Our prices in microfinance are bewilderingly complex, as this section will demonstrate. How did we get to this situation? What are the negative aspects of non-transparency? And how do we work our way out?

Financial prices are the most complex of prices

Our clients always ask us the price of the loan, as they do with any product they buy. We respond with an often complex array of price components:

- There is nearly always an “interest rate” given, but what time period the figure is for varies, as does the manner by which the interest charge is calculated and paid
- There are often one or more fees assigned
- There are commonly additional “services” the client must also purchase, such as insurance
- Quite common in microfinance, much more so than in commercial finance, is the “required savings” or security deposit

This array of cost components masks the true total cost of the loan, as some examples will show.

Which loan would you choose?

No one can deny that for most micro-loan products in the world, we present the price in confusing and opaque ways. First, let’s consider an *easy* example, where we look at exactly the same loan amount and loan term from four different price policies.¹

	Zero Interest Loan	Interest and Fees	And Savings	Interest Only
Loan amount:	R1,000	R1,000	R1,000	R1,000
Loan term:	10 weeks	10 weeks	10 weeks	10 weeks
Interest Rate:	0%	15% “flat”	12% “flat”	40% <u>decl</u>
Upfront fee:	5%	2%	1%	0%
Security deposit:	0%	0%	20%	0%

¹ Note that in these examples, “security deposit” is money that is generally marketed to the client as a “savings account”. The money is unavailable to the client during the loan and returned to the client once the loan is completely repaid.

It doesn't look at all clear, does it? So maybe, as do clients, you decide to ask what the total amount you pay back is – what we call the **Total Cost of Credit (TCC)**. You find out options 1 and 2 both cost R50, Option 3 costs R33, and Option 4 costs R42. So what do you choose now? Option 3? Or is something suspicious going on with that security deposit?

Using the Annual Percentage Rate (APR)

When using the Annual Percentage Rate (APR) as a means to calculate the true price, you get some surprising answers. The first three options have nearly identical APRs, and Option 4, which seems to be the highest price, is actually the lowest price. Even we, who have education and experience in finance, find it challenging to determine the true prices of loans. Why do we think our clients can do any better?

Which loan would you pick?				
	Zero Interest Loan	Interest and Fees	And Savings	Interest Only
Loan amount:	R1,000	R1,000	R1,000	R1,000
Loan term:	10 weeks	10 weeks	10 weeks	10 weeks
Interest Rate:	0%	15% "flat"	12% "flat"	40% <u>decl</u>
Upfront fee:	5%	2%	1%	0%
Security deposit:	0%	0%	20%	0%
TCC	R50	R50	R33	R42
APR	49%	47%	49%	40%
Transparency Index	0	32	25	100

The Downward Spiral and the Transparency Index

We have progressively fallen into the trap we call the "downward spiral". MFIs can start out with everyone charging reasonably transparent prices. A few of the MFIs with the highest prices decide to make their prices less transparent, first switching from declining balance interest to flat interest, then adding fees, and then adding security deposits. Once a few start, more join them, and in the end it is hard for any MFI to explain why their "high" transparent price is really *lower* than everyone else's "low" opaque price.

Notice the bottom line in the previous figure, labeled "**Transparency Index**". This is MFTransparency's approach to rate the transparency of a price. We take the annual interest rate as told to the client (e.g. 12%) and compare it to the APR (e.g., 47%), resulting in a score of 32. A perfectly transparent price, like in Option 4, earns a score of 100. How transparent are prices in microfinance? Of the data MFTransparency has collected in 28 countries around the world, we find Transparency Indices varying by country. The most transparent countries have an overall index in the 80's or low 90's. Other countries have indices below 50, meaning that less than half the true price is communicated to the client.

What is the APR, and how is it Calculated?

For countries that have established Truth-in-Lending legislation, the process legislated is nearly universally a variant of the APR.² But the APR seems like a mysterious and confusing figure to many clients and even to some of us in the financial industry. In reality, the APR is an extremely useful and logical concept. When a client gets a loan, she is not *buying* money. If she were, the TCC would make more sense. Instead, she is *renting* money, and this is the key point:

The APR is the unit rental charge to rent one unit of currency and keep the full unit for one year.

An APR of 30% means that if I borrow \$1.00 and keep the entire \$1.00 for 12 months, I pay \$0.30 in rental cost, i.e., interest and/or fees.

The concept of *unit* rental cost is important because few loans allow the client to keep the entire loan balance for the entire loan period. The client pays back a portion each week or month, and in many cases never even gets the full loan amount disbursed because of fees and security deposits deducted at disbursement. Thus, when we tell a client “You can borrow \$1,000 for twelve months and the TCC is \$160” that does not mean the interest rate is 16%. The client is making regular principal payments and can have an average balance of perhaps \$542 over those twelve months. The declining balance interest rate (and APR) of this example is actually 30%, as the client is paying \$160 to rent an average of \$542.

Renting, not buying, is the point to emphasize, and we see parallels in other areas where consumers rent. When we rent office space, we are told the annual rent (the equivalent of the TCC). However, when shopping for office space, we generally also ask the “price per square meter” (the equivalent of the APR). This is a helpful analogy for understanding loan pricing, however loan prices are much more complicated.

Consider how flat interest is calculated – on the *original* loan amount, not the current balance. This is like being charged rent of \$1000/month for an office of 100 square meters, but every month you have to vacate another 8 meters of space. In the last month, you would be crammed into just the last remaining 8 meters, but still be paying \$1000 for rent. That certainly makes no sense, but that is precisely how flat interest is calculated.

Can TCC be a Near-Substitute for APR in Some Conditions?

Despite the accuracy of the APR, there are many who believe that TCC might be a progressive step toward APR. Clients gravitate toward “real numbers” like TCC and are confused by abstract percentages like APR. Therefore, can we use TCC to help clients decide? The TCC seemed to work for three of the four examples in our simple example. Can it be used as a simpler alternative for communicating the true price most of the time?

² Another common term is Effective Interest Rate, or EIR. The APR and EIR approaches use different formulas when annualizing the cost. For more information please refer to materials at www.mftransparency.org

Let's consider some different examples. First, when amounts and terms vary, the TCC gets quite difficult to use to compare loans. Here are three examples with TCC ranging from \$240 to \$920. Because of the loan amounts and terms, the \$240 is the highest price, and the \$920 is the lowest price. With some basic business sense and a calculator, a client might be able to work through some comparison figure, but the APR would cut straight to the figure they need.

Which loan would you pick?

	Loan 1	Loan 2	Loan 3
Loan amount:	\$1,000	\$1,000	\$4,000
Loan term:	6 months	18 months	12 months
Interest Rate:	36% p.a. "flat"	3% mon. "flat"	22% p.a. "flat"
Upfront fee:	\$60	2% fee, 1% ins.	1%
Security deposit:	20% up-front 10 each month	20% upfront	10% upfront
Total Cost Credit	\$240	\$570	\$920
APR	129%	91%	48%
Transparency Index	28	39	45

Secondly, there is an underlying assumption that the repayment schedules are identical for loans of the same amount and term. This may not be true, and those lenders interested in maximizing their portfolio yield can manipulate the product to increase their profit. Here are three loans, of the same amount and term, and have identical flat-interest rates, no fees, and no security deposits.

Loan 1 uses the technique of "up-front" interest, where interest for the entire loan term is calculated and paid at loan disbursement. In this example, the client gets only \$640 and pays back \$1000, rather than getting \$1,000 and paying back \$1,360. The MFI gets to use the interest money for the entire term of the loan, and the client has fewer funds during the life of the loan. Because of the time value of money, the result is a much higher price for the client.

Which loan would you pick?

	Loan 1	Loan 2	Loan 3
Loan amount:	\$1,000	\$1,000	\$1,000
Loan term:	12 months	12 months	12 months
Interest Rate:	36% p.a. "flat" Paid upfront	36% p.a. "flat" Paid monthly	36% p.a. "flat" Paid monthly
Grace period	No	3 months grace	No
Total Cost Credit	\$360	\$360	\$360
APR	91%	51%	61%
Transparency Index	39	71	59

Loan 2 uses flat interest, but provides the client with 3 months of grace at the beginning of the loan.

The irony of flat interest is that the client has the use of *more* money for more time, i.e., the average balance over the twelve months increases, but the client isn't charged *any* additional interest. The result is a cheaper unit rental price for the client. Loans with declining balance interest result in the same APR regardless of grace periods because total interest payments increase or decrease correlated to the grace periods.

Loan 3 is a "conventional" loan with flat interest – no grace period, constant monthly payments, with interest and principal in each payment. The result is an APR of 61%, somewhere in the middle of the other two loans. Thus, a Total Cost of Credit of \$360 for these three "identical" loans results in APRs ranging from 51% to 91%.

NON-TRANSPARENCY IS A MARKET IMPERFECTION

Lack of Clarity on Prices Inhibits Competition and Consumer Decision

Markets need clear information, and they particularly need clear information on something so important as the sales price of the product. Without this information, stakeholders make poor decisions. As we have seen, microfinance has a serious problem with transparent pricing information. Products seem cheaper than they are, and that results in consumers over-consuming. Following are some quotes on pricing transparency from leaders in the industry.

Elizabeth Littlefield, former CEO of CGAP states the following:

“Greater transparency ... will lead to lower costs, increased efficiency and will empower customers to make the best choices they can. Transparency and comparability of prices will lead to more efficient markets and downward pressure on costs that will benefit millions of poor people.

“Pricing transparency aims at giving microfinance institutions 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.”

Asad Mamood, Deutsch Bank, says:

“Transparency is the root of every healthy industry. It is fundamental to good business practices.”

Robert Annibale, Citibank, says:

“Transparent and consistent pricing ensures that clients can compare the effective interest rate of lending products across institutions while donors, investors and analysts can better assess lending institutions from a financial and social perspective.”

Truth-in-Lending as a Means to Address Non-Transparency

Opaque pricing is nothing unique to microfinance. Rather, microfinance has borrowed the ideas invented by those who came before us. As we have seen, true prices are often impossible to determine. To correct this market failure, regulators in a large and growing number of countries require lenders to conform to Truth-in-Lending regulations, whereby at some point in the sale of the loan, the lender must communicate a standardized figure such as the APR. Truth-in-Lending legislation covers only a small portion of the global microfinance industry. Current legislation is summarized and compared at www.mftransparency.org.

We should all advocate for expansion and improvements in Truth-in-Lending to help all stakeholders in microfinance make better decisions on pricing.

SECTION 3. THE PRICE CURVE RESULTING FROM THE COST CURVE

This section presents some fundamentally important information by looking at high level financial data from hundreds of MFIs in many countries. What we find is quite interesting. Our mission statements lead us to target a particular segment of clients, such as very poor rural farmers, or struggling lower-class urban microentrepreneurs. We develop delivery methodologies to get loans to those clients in an efficient manner. We then set prices to try and cover delivery costs and possibly generate profit. And what results after all of this is that we do not have anything like uniform efficiencies and uniform prices in microcredit. Instead, we find two very distinctive and inter-related curves, where both the operating cost ratio and the portfolio yield are highly correlated to average outstanding loan balance of the MFI.

PRICING FOR SUSTAINABILITY

Before investigating the data, let us first review the fundamentals of income and expenses for financial institutions.

First, in general terms, the expenses of a financial institution are grouped into financial costs (what it pays for funds), loan loss expenses (to cover bad loans), and operating costs (salaries, rent, etc.). These expenses can be converted to percentages by dividing each of them by a common denominator, and then these percentages can be analyzed and combined with a profit margin to determine the targeted portfolio yield for the institution. The following figure shows the formula as presented in CGAP Occasional Paper 1 (Nov 2002). Using typical benchmark figures of the time shows that the MFI should target an average portfolio yield of 37.8%.

Calculating Target Portfolio Yield

		Expenses			Profit	Income																									
		25.0%	+	2.0%	+	8.0%	+	3.0%	-	1.0%																					
		(OC)		(LL)		(CF)		(K)		(II)																					
Targeted Portfolio Yield	=	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;"></td> <td style="width: 5%;"></td> <td style="width: 15%; text-align: center;">1</td> <td style="width: 5%;"></td> <td style="width: 15%; text-align: center;">- 2.0%</td> <td style="width: 5%;"></td> <td style="width: 15%; text-align: center;">0.37</td> </tr> <tr> <td></td> <td></td> <td></td> <td></td> <td style="text-align: center;">0.98</td> <td></td> <td></td> </tr> <tr> <td></td> <td></td> <td></td> <td></td> <td style="text-align: center;">37.8%</td> <td></td> <td></td> </tr> </table>											1		- 2.0%		0.37					0.98							37.8%		
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				0.98																											
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<i>All expressed as % of avg loan portfolio</i>	
OC	Operating Costs
LL	Loan Losses
CF	Cost of Funds
K	Desired capitalization Rate
II	Investment Income

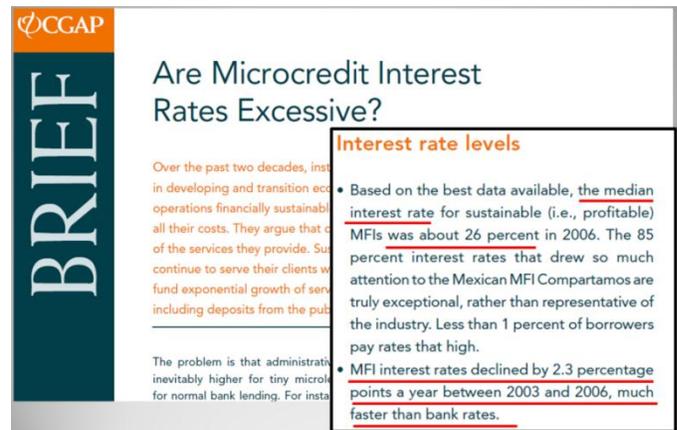
The largest figure in that formula is the Operating Cost Ratio (25%). Ten years ago, 25% was considered an acceptably low level, representing an efficient institution. Now we expect, and see, figures much lower than 25% and many analytical reports credit this to increased competition, larger scale, and smarter managers. We'll see here, however, that there is an entirely different reason for "improvements in efficiency."

UNDERSTANDING THE PRICE AND COST CURVES

Microfinance has arguably matured and improved much in the past 15 years, partly due to a broad range of the industry working together to first reach agreement on a comprehensive set of financial ratios and then to consistently report on those ratios. This commitment to business ratios took place in the early stages of the industry shifting from a project orientation to a sustainable business orientation.

Together with this transition, the industry started to draw in a much larger percentage of analysts experienced in commercial finance and business. We saw an increase in the quantity and quality of analytical reports, and we saw an increase in the application of standard business theory to microfinance. Quite regularly, these reports and the accompanying analysis were based, and continue to be based, on the assumption that "all micro-loans are the same." As will be demonstrated in this section, they clearly are not. This failure to adequately adapt conventional business theory to microfinance reality has led to a wide range of erroneous conclusions.

We will here draw out two significant issues. First, **there is no "one market price" for micro-credit**. Rather, there is a price curve – higher prices are charged on smaller loans. Second, **the price curve is generally a direct result of the reality of a cost curve** – the operating cost ratio for loans increases (and increases quite dramatically) as loan size decreases. I should point out that other interesting factors result in curves as well, e.g., there is a price curve when comparing short-term to longer-term loans as well, however, demonstrating that correlation requires more sophisticated data sets that have not been available. *MFTransparency* has collected that data and will publish an analysis in Paper 2 of this series.



The Price Curve

Is There an Average Price for Microcredit?

For various reasons, the microfinance industry long ago adopted the position that one particular ratio – the average portfolio yield of the institution – was an adequate representation of the price of their loans. This is

quite incorrect for two reasons. First, Truth-in-Lending legislation always examines factors that go beyond simple portfolio yield, as the examples in Section 4 showed necessary.

Second, the assumption of averages leads to erroneous conclusions in microfinance. Nearly all reports on prices – whether ratings reports of a single institution, country network statistical reports, or global pricing analyses – calculate average portfolio yield, as the example from the 2009 CGAP Brief “Are Microcredit Interest Rates Excessive?” shows.

In that excerpt, CGAP makes two claims about interest rates – average prices are an adequate measure of true pricing, and average price trends are useful for examining changes. We will first evaluate the utility of calculating average interest rates. For a different interpretation of what price trends really mean in microfinance, refer to the material at www.mftransparency.org.

Many analytical reports, such as the CGAP brief above, are based on data provided by the MIX. The MIX data is extremely useful, and we use it a great deal in this paper. However, it is important to emphasize that *good microfinance data does not always result in good microfinance analysis*. The peculiarities of microfinance must be understood and taken into account in the choice of analytical methods in order to reach useful conclusions.

Examining the Price Curve

Comparing prices among different countries adds complications that we will address later in this section. At this stage, we will first look at country-level data. The graph to the right shows 2009 portfolio yield data for 59 MFIs in the Philippines. The institutions are arranged from lowest yield to highest yield, and the line shows the average yield.³ In this case the average yield is 33%, and we are given no explanation for why prices range so widely, from 14% to 72%. The obvious question is: Are those MFIs with prices below 33% *fairer* than the others?

Most recent discussions on defining “responsible pricing” proceed to use this same data and carry

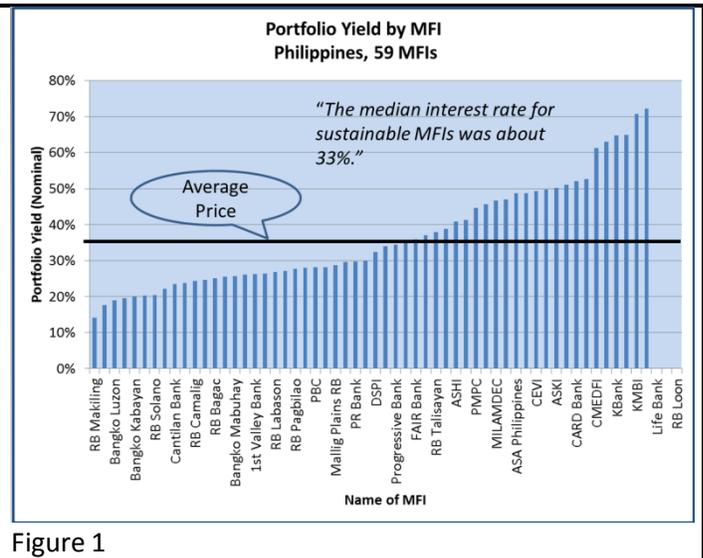


Figure 1

³ The median yield is then often quoted as the median *interest rate*, even though fees are included in the yield calculation, and the true price of a loan is certainly more than just the interest paid.

through to the next step of defining a price band, a range of prices justifiably close to the average market price. Figure 2 adds a hypothetical band representing a “responsible pricing range” for the Philippines. MFIs charging above this range are often argued to have prices that are “too high,” while some also argue that MFIs with prices below this range are “too low” (possibly because they are subsidized and therefore distorting the market).

This all seems logical and justifiable from basic, rational business logic. The methods applied are similar to what would be applied to conventional businesses. These are tools we are taught when we get our MBAs. A different perspective, however, presents this same Philippines data in a considerably different light.

Figure 3 shows the same data from a different perspective. The portfolio yield data for the same 59 MFIs is now correlated to “average outstanding loan balance” of the MFIs.⁴ What becomes quite clear now is that those MFIs with the lowest prices tend to have the largest average loan balances. Those MFIs with the highest prices have the smallest loan balances. In other words, *not all micro-loans are the same*. These all fall under the national definition of a micro-loan in the Philippines, but as an MFI makes efforts to provide loans to poorer clients, they end up charging higher prices to those clients.

If true, this seems a bit discomfoting. It appears that the poorer the client, the higher the price we charge. Is that fair? Is that ethical? Are we guilty of taking advantage of the most vulnerable? Or are there other factors at work here?

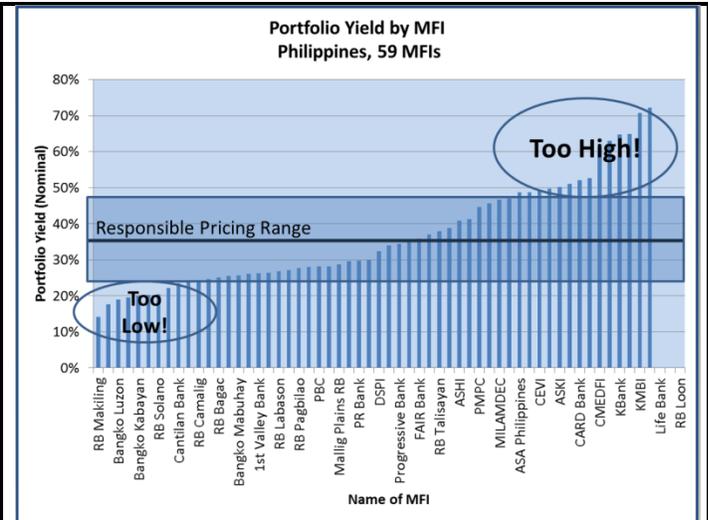


Figure 2

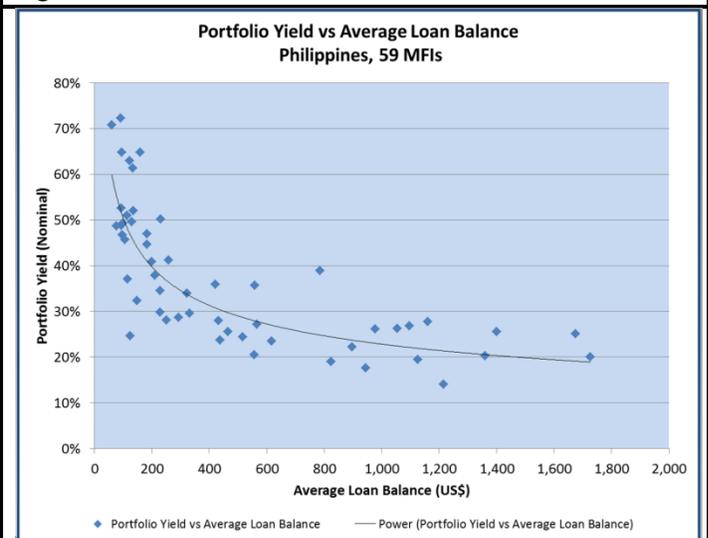


Figure 3

⁴ This figure is derived from financial information of the MFI, taking the total outstanding loan portfolio and dividing it by the number of active loans.

UNDERSTANDING THE UNIQUE REALITIES OF MICRO-CREDIT

To better understand this price curve, let us first look at some conceptual issues. We will then return to looking at real data for the Philippines.

Before the advent of microfinance, conventional commercial finance did not provide financial services for the poor. Commercial banking systems were not designed to provide loans below those limits, so the poor had to access credit from the informal sector. As shown in Figure 1, commercial loan prices generally did increase gradually as loan sizes decreased, e.g., a housing loan was less expensive than a car loan, and a car loan was less expensive than a consumer loan. The price line was therefore considered to be a gradual slope.

In its earliest years, microfinance started by charging prices that were below market rates of larger commercial loans. In the 1980's, micro-credit interest rates were often no higher than the inflation rate in the country, as it was argued that the poor could not, and should not, pay higher rates. Concerns about sustainability of financial services then led to rates starting to increase in the late 1980s. Within a few years, microcredit prices exceeded commercial finance rates, and we started to describe a continued sloped line shown in Figure 2. We argued that the costs of delivering micro-loans necessitated us charging somewhat higher interest rates.

A significant number of countries had usury laws in the 1990s, or have since implemented them, in reaction to concerns about prices being charged to the poor. The usury cap is generally based on the assumption of the sloped line shown in Figure 3. The intent of the usury cap is to let fairly priced products exist while protecting the poor from excessive prices (and profit-making).

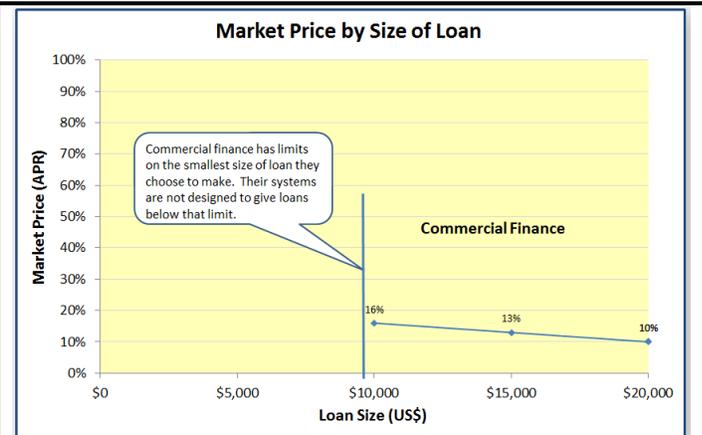


Figure 1

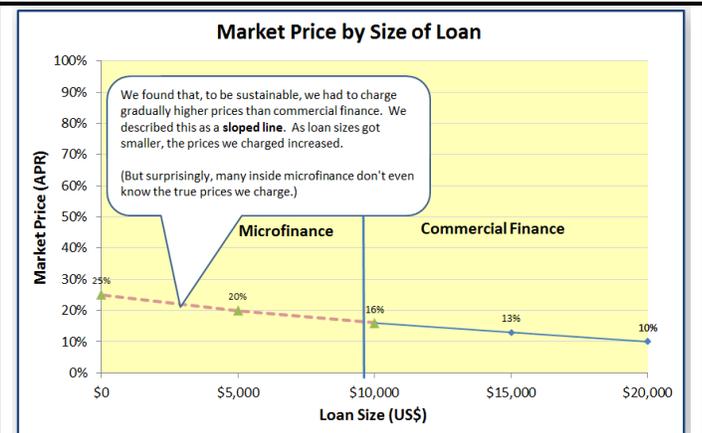


Figure 2

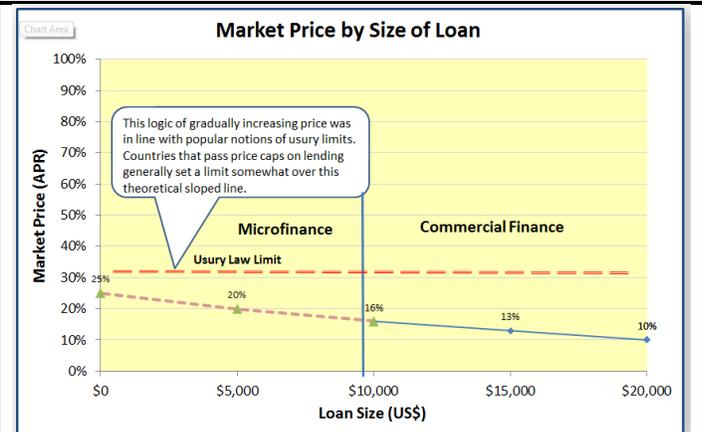


Figure 3

Do these caps work? We can use an extreme example in a thought experiment to test this assumption. Let's assume an MFI wants to provide a loan of \$1 for a full year and needs to cover costs (Shown in Figure 4, with the x-axis now zoomed in on just micro-loans). Let's say that the MFI works very efficiently, spending only \$2 per month to monitor the client and the loan, spending a total of \$24 for the year. Just to cover these operational costs by generating \$24 in income, the loan would need to be priced at 2400%, far in excess of the usury cap.

Of course, we can argue that a loan of \$1 for one year makes no sense, but there is clearly some point where a loan is too small to be provided sustainably when priced below the usury cap of 30%. In other words, the sloped line matches reality up to a certain loan amount, but *the line must transition into a curve as the loan amount approaches zero*. This dramatic increase in price does not reflect profit – it is simply a necessity to cover extremely efficient costs.

The inevitable result of a usury limit is that loans below some certain amount will either disappear or will need to be subsidized by the lenders (possibly subsidized by profits made from larger loans). In either case, the likely result is a reduction in the supply of the smallest loans offered by formal institutions and the poor return to their informal credit sources.

For these reasons, the microfinance industry has been very preoccupied with price caps for many years, and this concern has led to some of the practices at high levels in the industry to be less transparency of true prices. In countries where caps do not exist, there is concern that if true prices

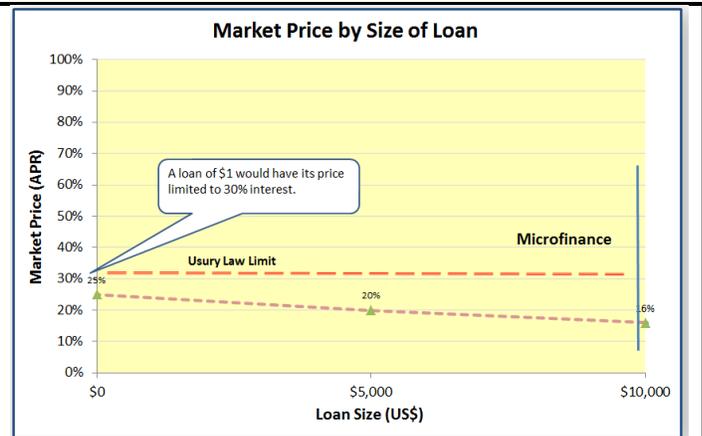


Figure 4

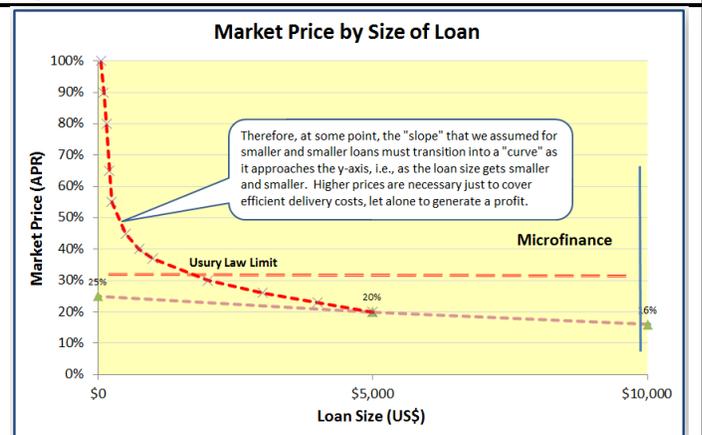


Figure 5

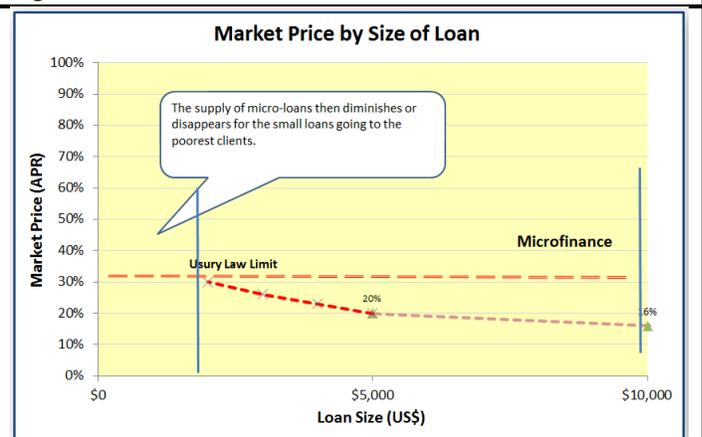


Figure 6

become known, that the reaction will be to implement price caps.

I maintain that once we recognize and document the reality of the delivery cost curve and the resulting price curve, there is the potential to educate all stakeholders to better understand financial prices. *With increased knowledge and transparency, true price competition can lead to better decisions by all stakeholders.* Arguably, markets that do not practice transparent pricing are imperfect markets and price competition is absent. With increased competition there is more incentive to seek out innovations and efficiencies. As depicted in Figure 7, microfinance can continue to achieve improved efficiencies, and with increased competition these efficiencies lead to lower prices on microloans.

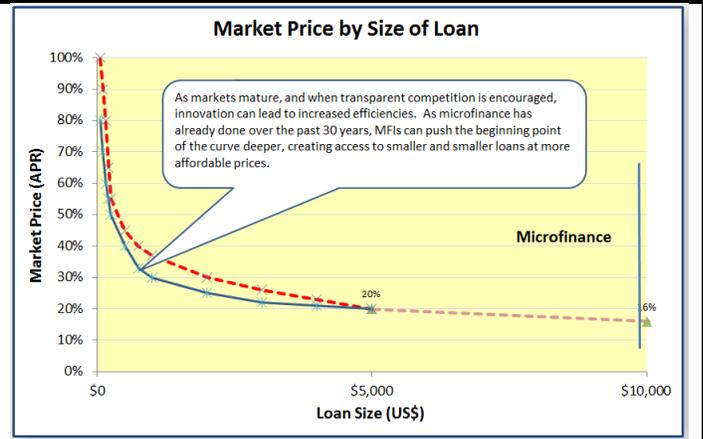


Figure 7

COMPARING PRICING THEORY TO REAL PRICING DATA

Is the above theory of price and cost curves reflected in real data? In certain markets, yes. Those markets with a relatively high degree of maturity and competition do show a strong correlation between delivery costs and prices charged.

Returning to the Philippines data, we now compare the Operating Cost Ratio information (red line) to the Portfolio Yield data (blue line) for the same 59 MFIs.

Each MFI has two data points, and they are vertically aligned because that MFI has one specific average loan balance. The red and blue lines show the

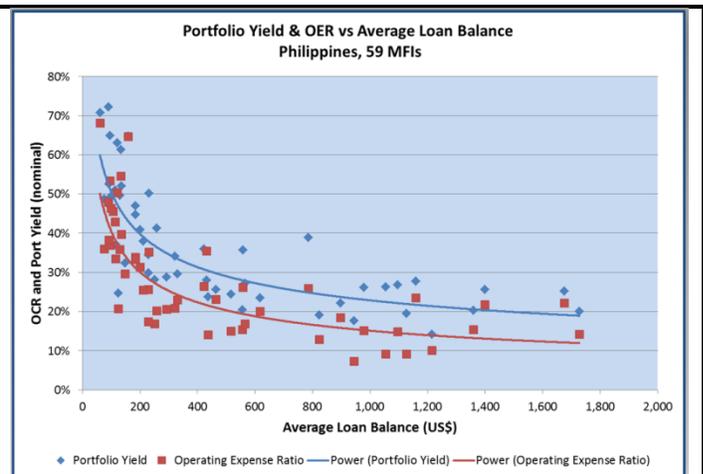


Figure 1

average costs and average prices of the MFIs. There is an undeniable correlation between the average operational costs and the average portfolio yield across the entire continuum of loan sizes.

What is the gap of about 10% between the operational costs and the yield? It represents additional income necessary to cover financial costs and loan losses. If anything is left over, then there is profit.⁵ The obvious conclusion: *High prices do not mean high profits.* The hypothesis we should investigate further: High *spreads* (difference between portfolio yield and operating costs) likely result in high profits.

Do we see curves in other countries? Figures 2 and 3 show data for Peru and Ecuador. Both countries have curves, though not as dramatic as the Philippines. Peru has a fairly constant spread of approximately 15% between prices and costs. Ecuador has a consistent spread of about 12%, until loan balance drops below \$1,000. Then the spread reduces dramatically.

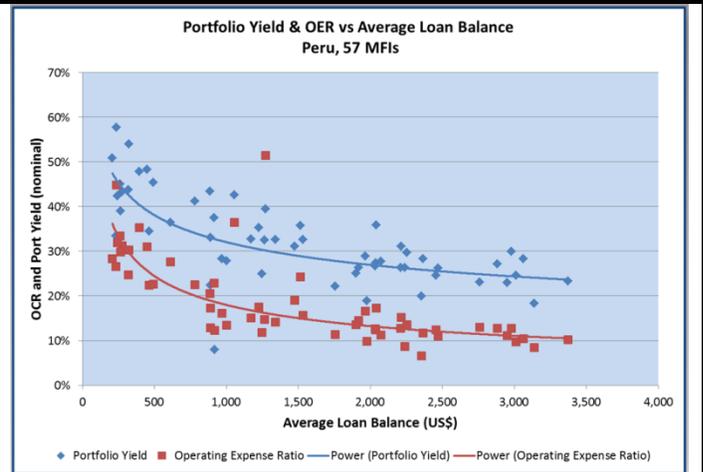


Figure 2

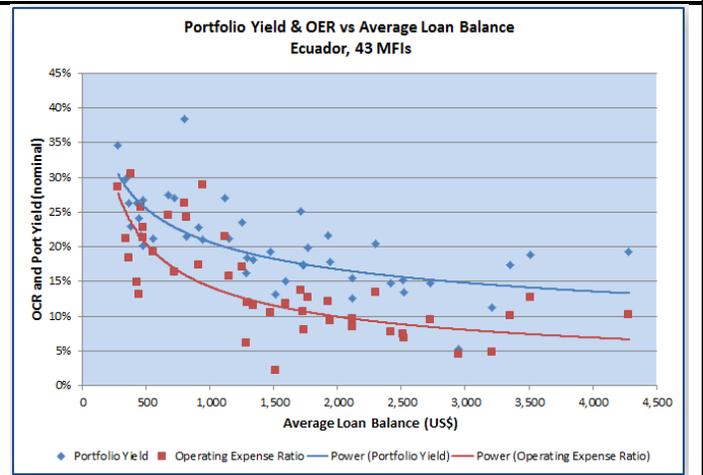


Figure 3

⁵ Note that the analysis is using average portfolio as the denominator in both figures, not average total assets. Therefore, there will be some variations between MFIs that have a different amount of their assets dedicated to portfolio. For this high-level analysis of market averages, the conclusions are sound. If drilling down to analyze a single MFI, then asset allocation should also be incorporated.

We don't see curves for all countries. Figure 4 shows data for 81 MFIs in India. The statistical averages of both costs and prices yield straight lines and are rather meaningless given the high dispersion in data. To investigate further, let's study cost curves for a variety of countries.

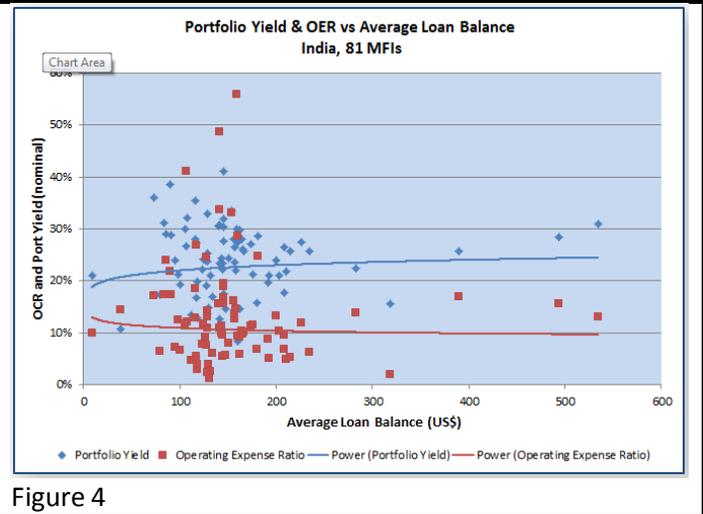


Figure 4

EXAMINING THE COST CURVE OF DIFFERENT COUNTRIES

Can we Compare Data from Different Countries with Different Economic Factors?

Let's examine the operating cost curves for a variety of countries and see what patterns emerge. As we do so, we will examine not just the shape of the curve, but also the values of the axes:

- What are the average loan sizes in that country?
- What range of operating cost ratio do the MFIs span?

We are showing countries which have a high number of MFIs reporting data to the MIX in 2009. Figure 1 shows data for Bosnia and Herzegovina, considered one of the mature and efficient markets in the

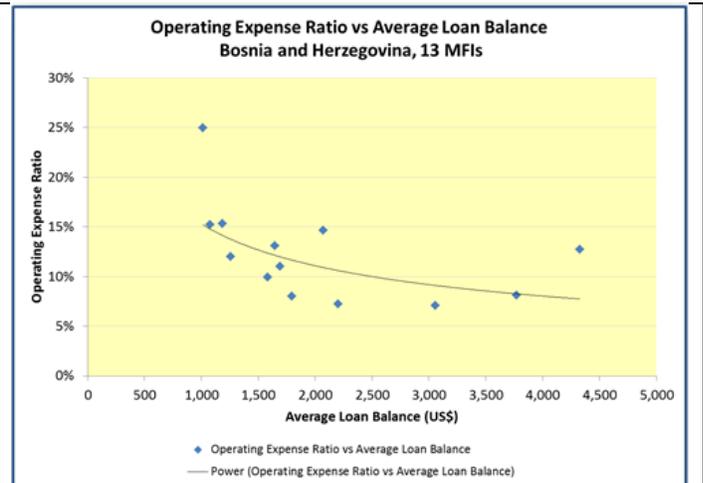


Figure 1

world. The data shows more of a sloped line than a curve, and the MFIs appear quite efficient, with all but one having an OCR below 15%. But notice that no MFI has an average loan balance below \$1,000. What might happen if MFIs in BiH gave smaller loans? Might there be more of a curve?

Figure 2 shows another much-discussed market – Mexico. There is a strong curve, though data is more disperse than with the Philippines curve. Notice that a large number of MFIs have average loan balances below \$500 – much smaller than in Bosnia and Herzegovina. And notice that nearly no MFI is as efficient as in Bosnia and Herzegovina, with over half the MFIs with OCRs ranging from 30% to 90%.

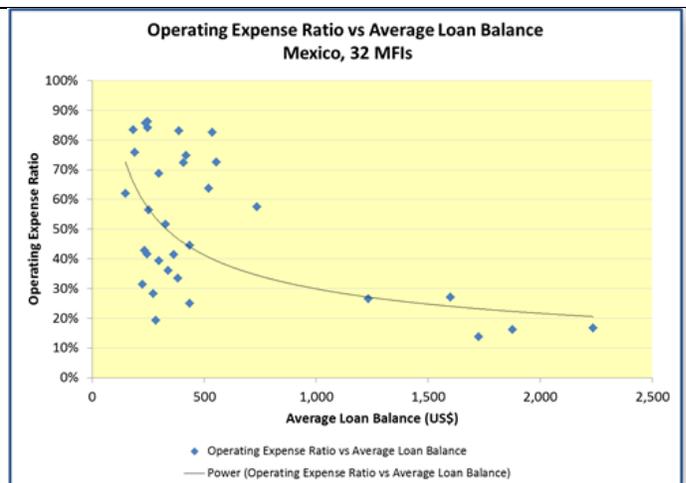


Figure 2

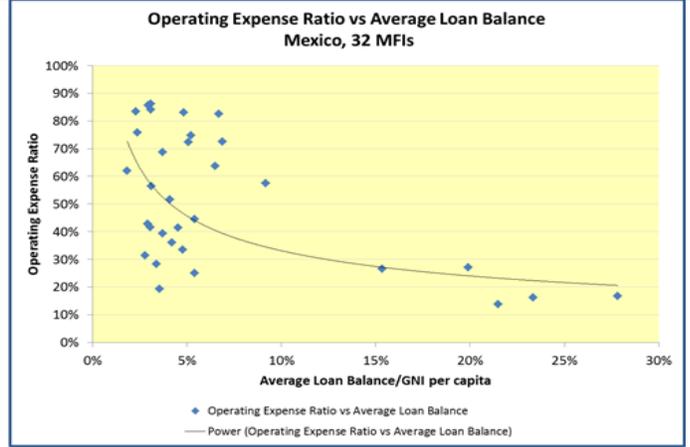
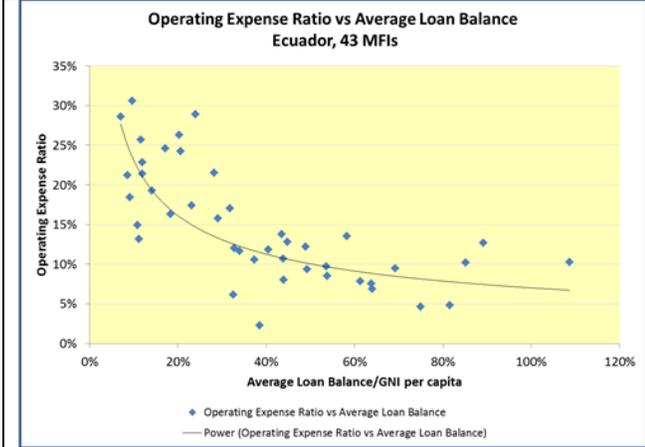
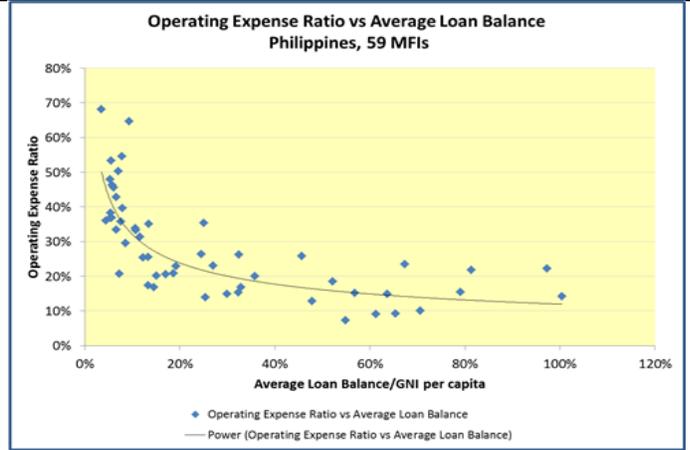
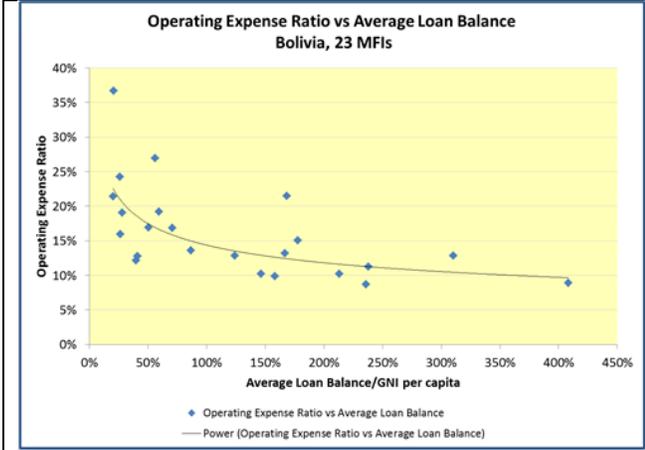
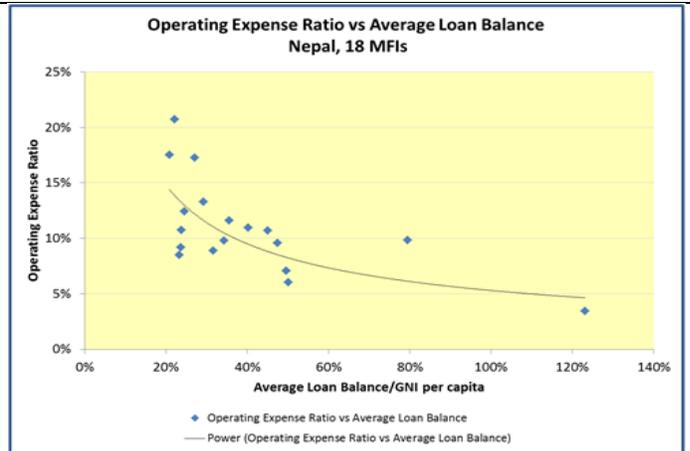
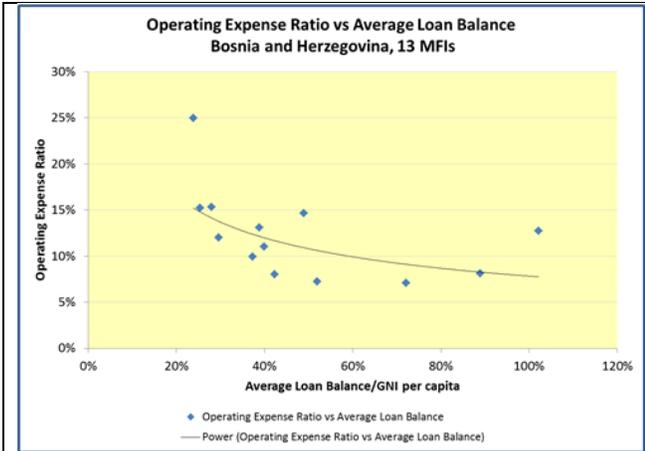
Converting loan balances to GNI/Capita

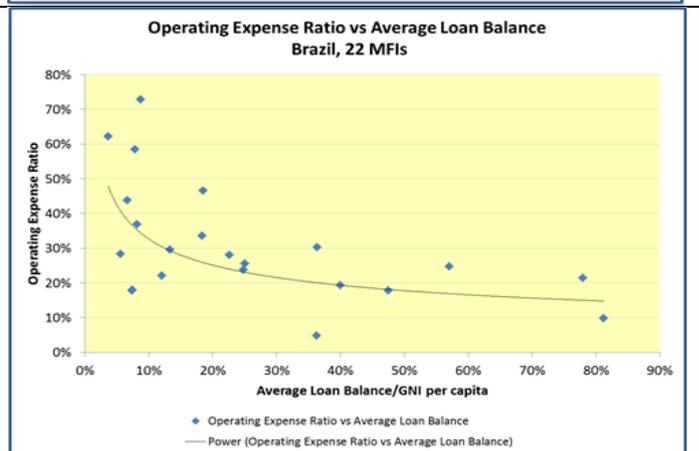
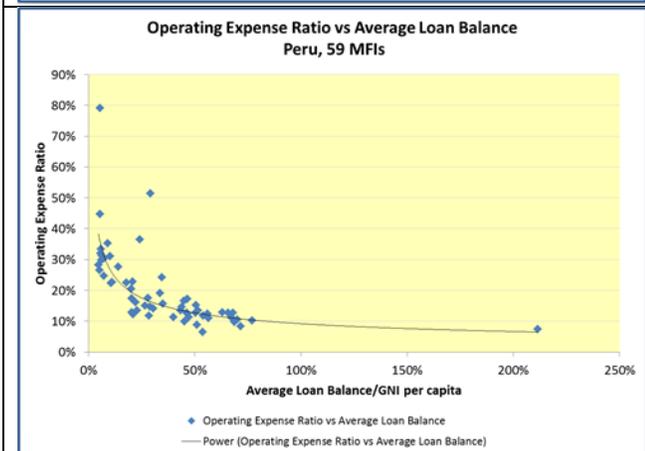
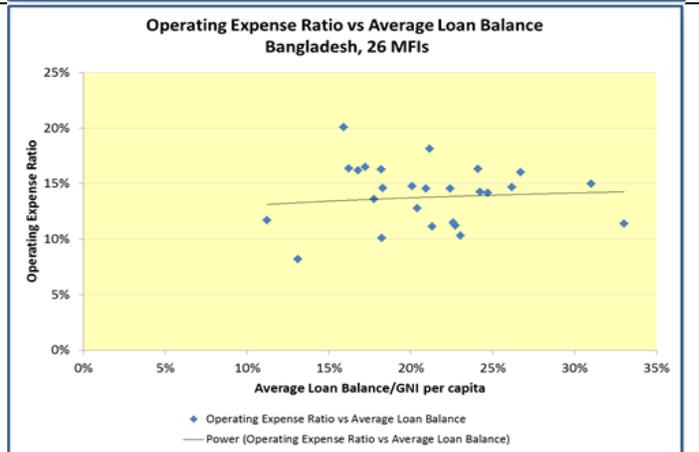
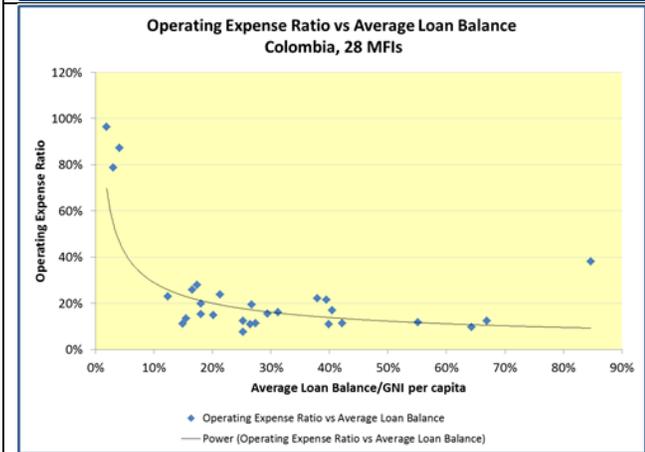
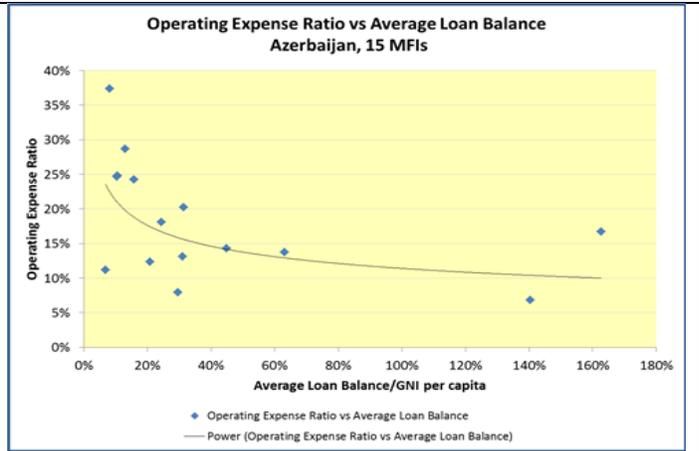
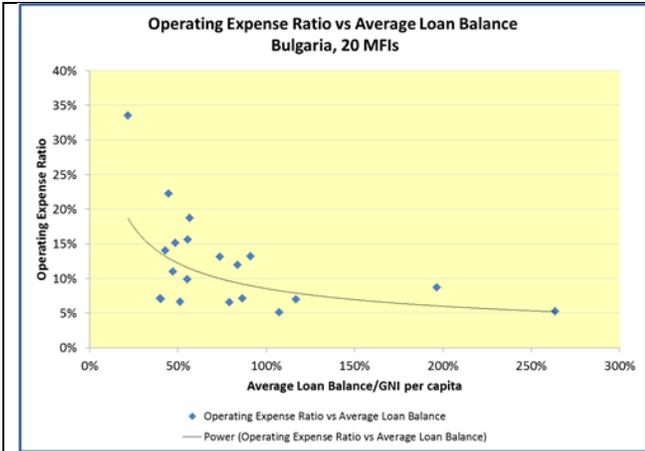
We can see that although there are interesting and relatively consistent patterns *within* a single country, we find significant differences *between* countries. We have argued that this is due to very different economies. But we can convert the monetary figures to Percentage of GNI per Capita so that they are more comparable. Doing so with the average loan balance gives a clearer indication of the size of the loan relative to the local economy. \$100 in BiH is not the same as \$100 in Mexico.

The following two pages of graphs show the Operating Cost Ratios for MFIs in a wide variety of countries, with the x-axis converting the loan balances in that country to % of GNI/Capita. Study them carefully for a few minutes, observing:

1. The shape of the curve,
2. The scope of loan sizes in the data set for that country – how small do the average balances get, and how large do the balances get relative to the GNI/capita, and
3. The range of Operating Cost Ratios – are they in the low, medium, or high range?

Our next section will help us to draw conclusions from this interesting data.





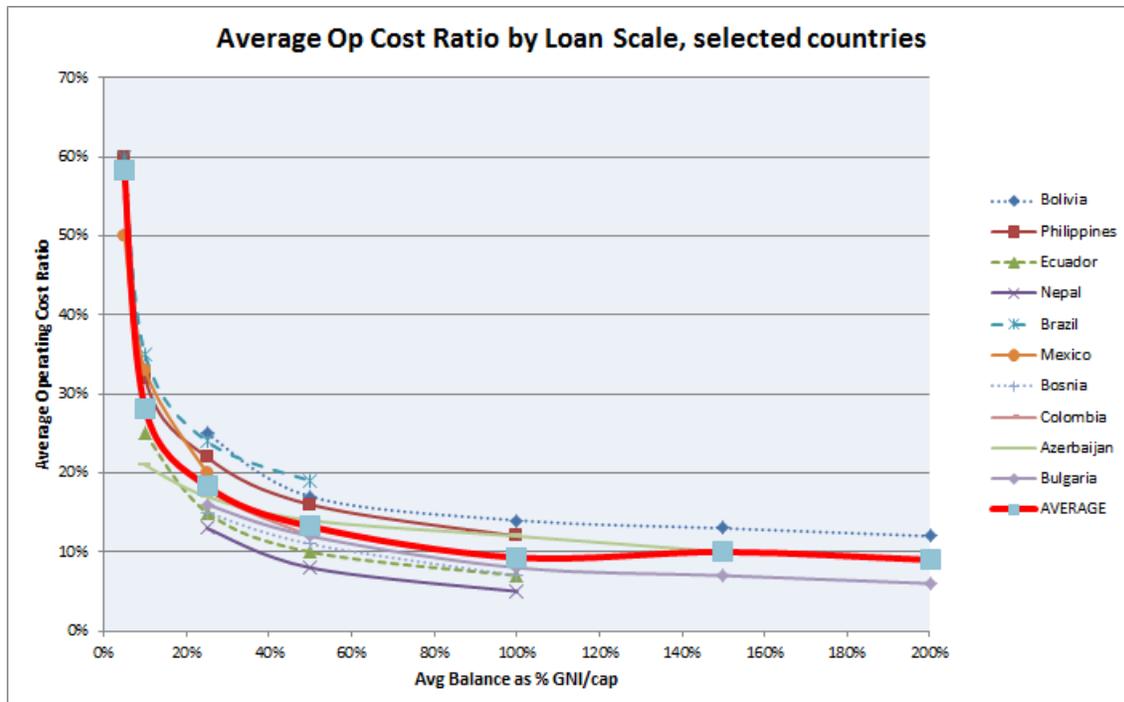
SECTION 4. A NEW BENCHMARK FOR OPERATING COSTS

Although there are dangers in studying data from too high a level, we can pull together this information by comparing the “average” lines of these countries. The following table shows the average OCR for ten of the countries displayed in the previous graphs, calculated for different levels of GNI per capita – 5%, 10%, 25%, 50%, 100%, 150%, and 200%. The countries are ordered, from left-to-right, as to the depth of their microcredit, i.e., Mexico spans the smallest loans relative to the local economy, with MFIs not even reaching the range of 50% of GNI/capita. On the opposite end, Bolivia and Bulgaria don’t have MFIs with average balances under 25% of GNI/capita, while they do have MFIs with balances up to 200% and beyond.

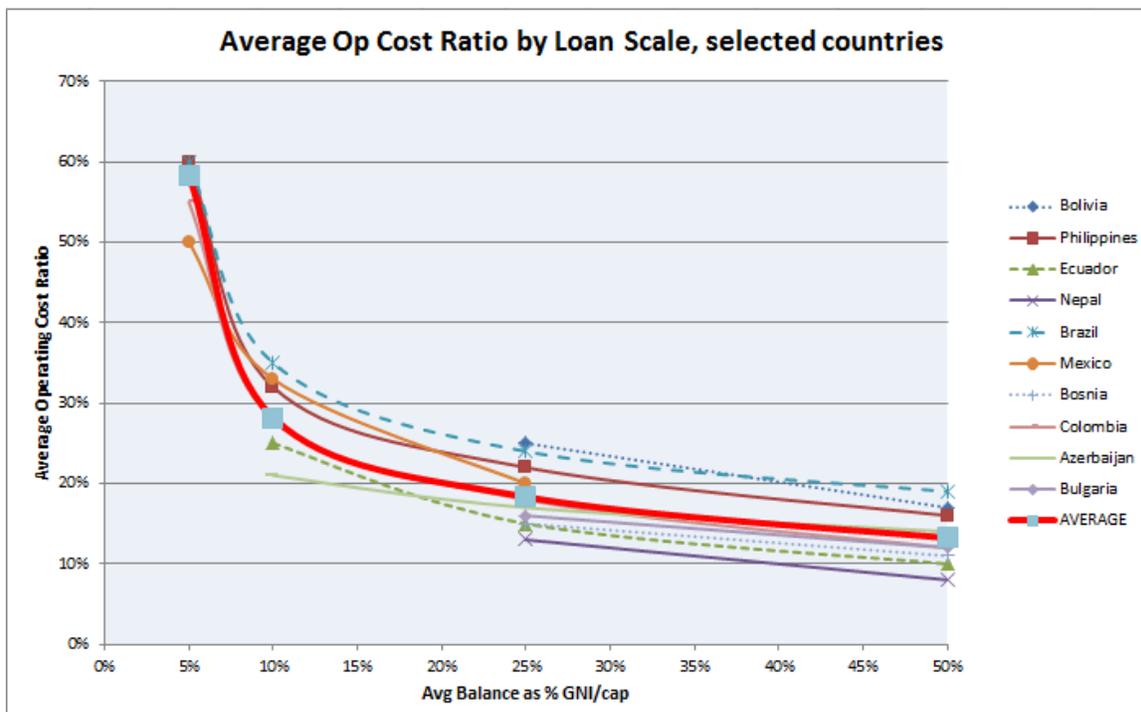
Operating Cost Ratio, average per county data											
GNI/Cap	Mexico	Brazil	Colombia	Philippines	Azerbaijan	Ecuador	Nepal	Bosnia	Bolivia	Bulgaria	Average
5%	50%	60%	55%	60%							58%
10%	33%	35%	28%	32%	21%	25%					28%
25%	20%	24%	18%	22%	17%	15%	13%	15%	25%	16%	18%
50%		19%	12%	16%	14%	10%	8%	11%	17%	12%	13%
100%				12%	12%	7%	5%	7%	14%	8%	9%
150%					10%				13%	7%	10%
200%									12%	6%	9%

In ordering the data this way, some striking patterns emerge. The four countries with MFIs having average balances in the 5% range have OCRs ranging from 50-60%. No other country has OCRs coming anywhere close to this level – it is only seen with extremely small average loan balances. This fairly consistent pattern continues at each increasing level of GNI/capita. The right-hand column calculates a simple average of the OCR for each level of GNI.

We can now look at this information on a comparative graph. The first graph shows the entire span, from 5% to 200%, with the thickest red line representing the global average that was calculated above. The shape of the curve, and where the curve starts, now provide some distinctive patterns, regardless of country. We see a very gentle slope for each country that has data for MFIs with balances greater than 100% GNI. From 100% to 50%, the OCR begins a more increased slope. From 50% to 25% the slope accelerates a bit more, and again from 25% to 10%. For balances below 10%, the “curve” nearly becomes a vertical line.



In the next figure, we zoom in, looking at data for balances only up to 50% of GNI. We do see quite clearly that, regardless of country, the “theory of the curve” that we developed in Section 3 is quite clearly drawn out. In any country that does not show a pronounced curve, it is because they aren’t giving small enough loans. If loans got small enough, the curve would certainly appear.

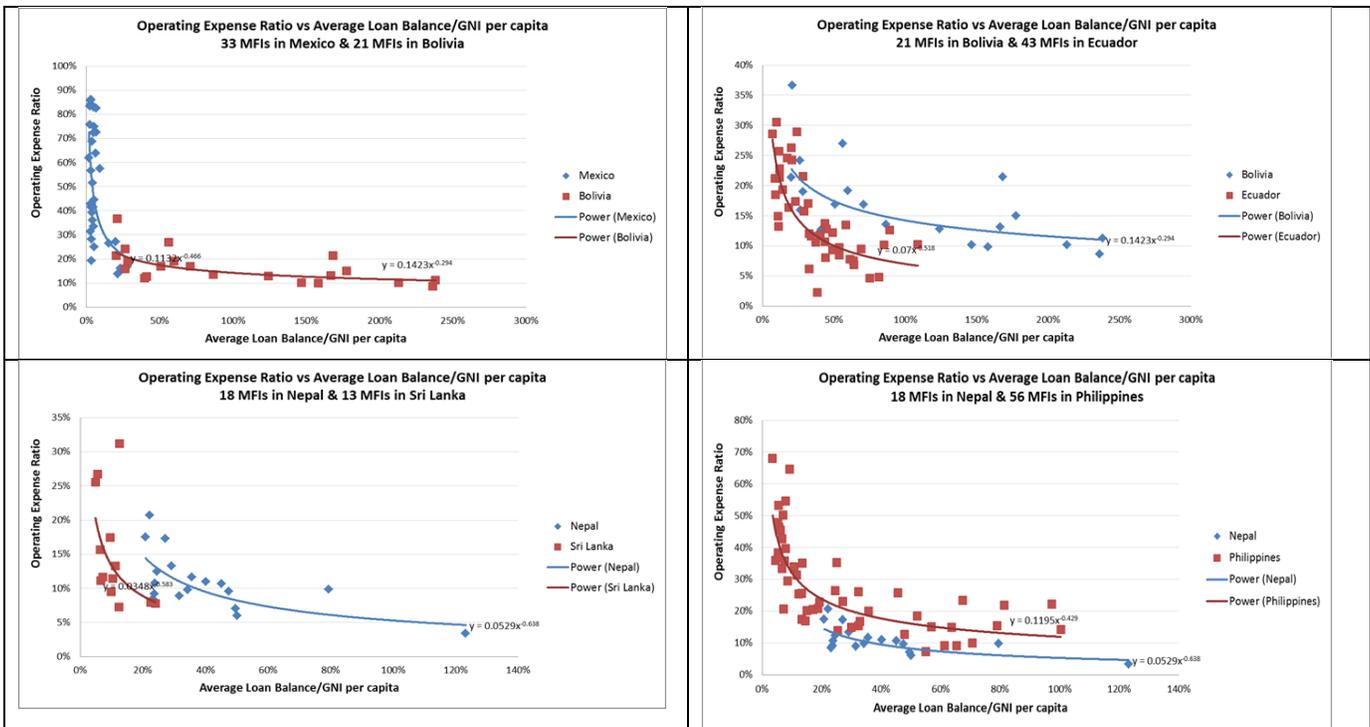


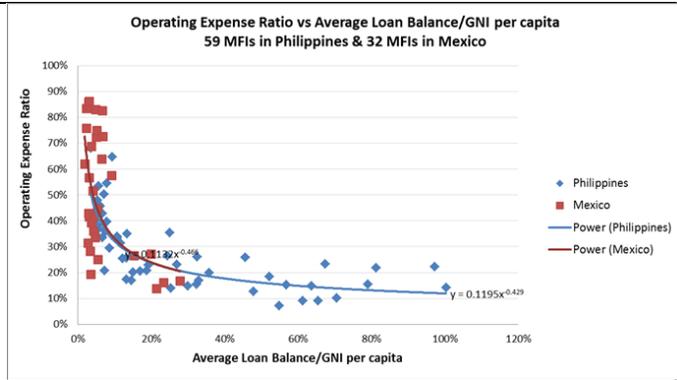
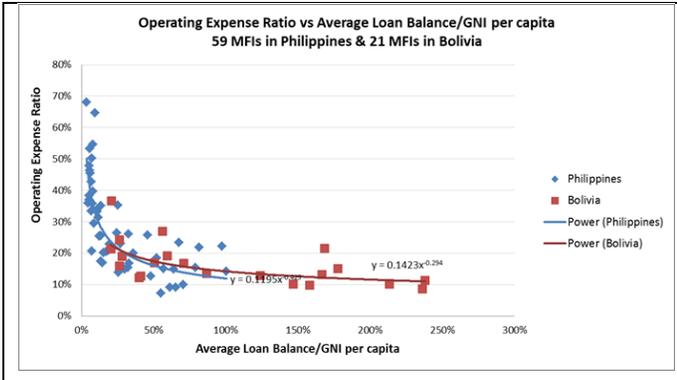
APPLYING THE BENCHMARK USING MULTI-COUNTRY COMPARISONS

This sheds a very different light on the cross-country comparisons we have been doing in microfinance.

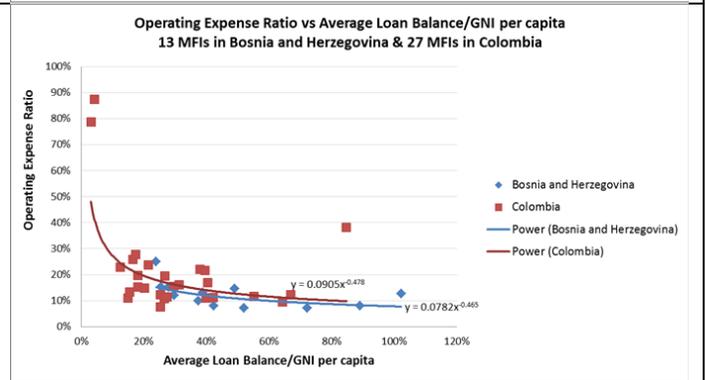
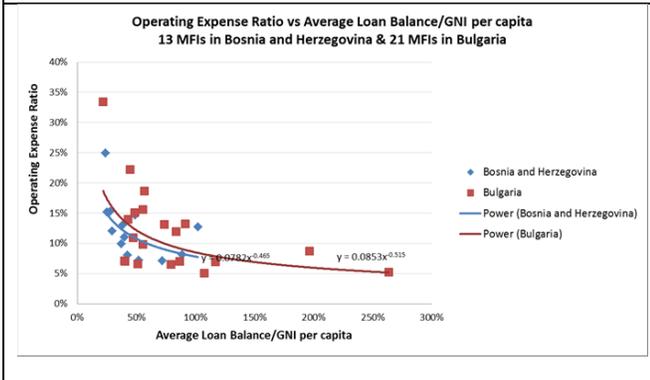
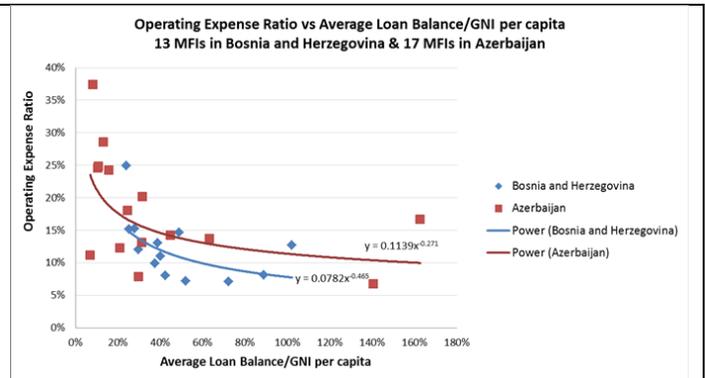
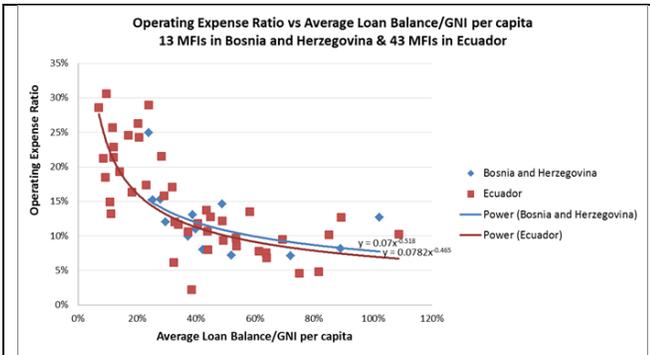
- Why are Bolivian MFIs so efficient? They give very large loans.
- Why do Philippine MFIs vary so widely in efficiency? They cover a broad span of loan sizes.
- Why do Bangladeshi MFIs have fairly consistent efficiency figures? They all have very similar loan products.

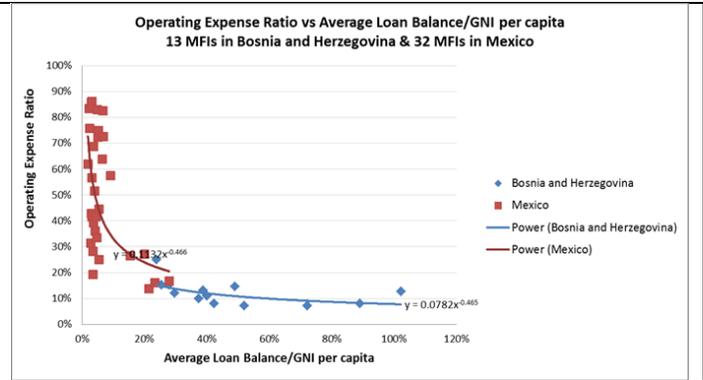
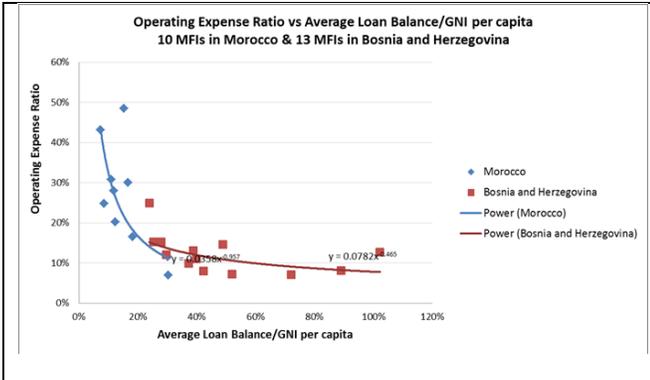
We can next compare OCRs from two countries on the same graph when converting loan balances to their GNI/Capita. We find striking differences in what loan amounts the MFIs in each country target, and we find that the different market focus does a lot to explain differences we see in efficiency levels. The following graphs compare a variety of countries within-region and across-region.





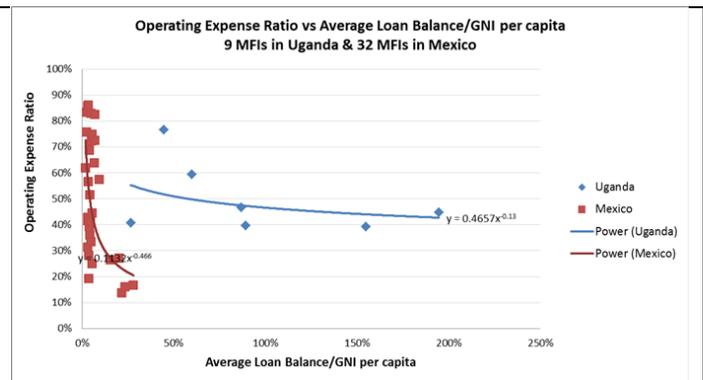
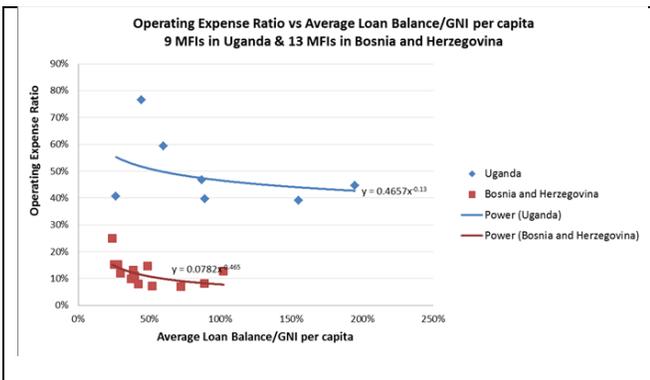
This next set of graphs compares just one country – Bosnia and Herzegovina, to a variety of other countries from other parts of the world, allowing us to see some interesting comparisons when we have one common denominator in each graph.





You will note that in the graphs I've shown, there have been no sub-Saharan African countries included. The primary reason is that for the country averages to be meaningful, the data set must be sufficiently large. There are few countries in Africa with a large number of MFIs reporting data to the MIX in 2009. Secondly, the data for few countries in the region shows data consistent with the curve principle we see in so many other countries in other regions. That is an important issue for further investigation.

Below are two graphs, using Uganda as an example, as Uganda does have 9 MFIs reporting data. The Uganda data represents MFIs with rather large loan balances, with only one MFI having a balance below 50% of GNI/capita. Therefore, the area for "the start of the curve" hasn't really been reached in Uganda. Despite the large loan balances, Operating Cost Ratios are much higher than they are for other countries giving loans of this size. The first graph, comparing Uganda to Bosnia and Herzegovina, shows that although loan balances are the same or larger, OCRs average over 40% instead of the 10% seen in BiH. The second graph shows that Uganda's OCRs seem comparable to Mexico's, but the loan balances in Uganda are ten times higher as a percentage of GNI/capita.



THE OTHER COST COMPONENTS – ARE THERE CURVES?

At the beginning of this section I had shown that the cost components are financial costs, loan loss, and operating costs. We have demonstrated a very clear curve for operating costs. In examining the data there is no significant correlation at all between loan balances and financial costs. Although they vary among countries, they can be assumed to be constant within a country, regardless of loan balance. The same is true for loan loss as a percentage of portfolio. And both figures are very substantially lower than operating costs. The

Operating Costs are both the largest cost component and the most variable cost component. Therefore, as show in the figure, the primary (perhaps only) reason for prices varying by loan amount is loan amount.

Pricing for Different Products

Component	\$100 Loan	\$1000 Loan
Financial Costs	10%	10%
Loan Loss	2%	2%
Operating Costs	50%	15%
Profit	3%	3%
Total Price	65%	30%

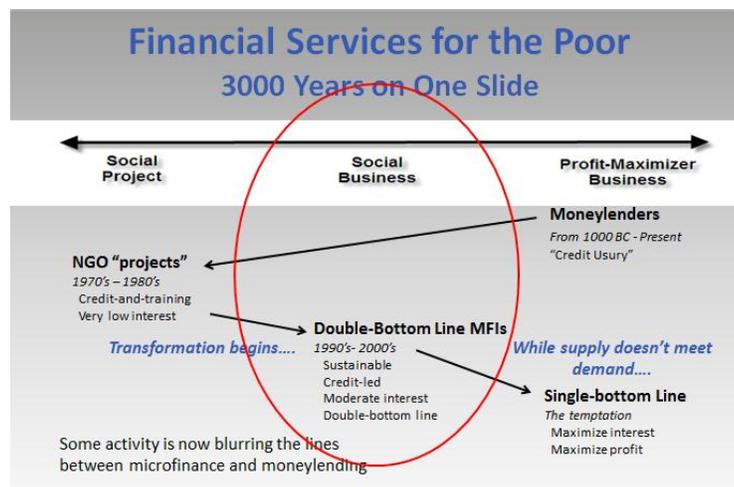
SECTION 5. THE BIND OF PRICES AND PROFITS – UNDERLYING ASSUMPTIONS THAT DRIVE CURRENT PRACTICE

We have examined the challenges of the costs required to get the very smallest loans delivered to the poorest clients, and how that results in an operating cost curve. We have seen how the market response of that cost curve is for MFIs to charge average prices that result in a price curve in order to be sustainable.

This section explores how the goal of becoming sustainable businesses emerged in microfinance and some of the ways it influences decisions.

THE BIRTH AND EVOLUTION OF MICROFINANCE

Our current version of microfinance was created some 40-50 years ago to be another alternative to the moneylenders. Initially started as subsidized social projects, we went through a transition to start moving toward sustainable double-bottom line businesses in the 1990's. We did so primarily by scaling up our level of activity, working at efficiency by reducing or eliminating the "credit-plus" services, and we increased income through raising the prices on the credit products. Many in the industry argued we should be more business-like and that rapid transition into the commercial market was a good thing. The expectation was business practice led toward sounder decisions, supply of credit would increase, and the poor would benefit.



The logic driving nearly all of that progression was standard business school logic, with the assumptions that proper market conditions were in place for fair competition. Sadly, that is not at all the case. In many places, microfinance operates in monopolistic or oligopolistic conditions (if we ignore informal sources). We almost universally operate without disclosing the full cost of credit products so that clients can make a reasoned comparison and choice. And, where economic theory assumes an "exchange of equals", a market transaction between sophisticated finance experts and our clients who have a very limited sense of financial analysis is far from a situation of equal power. An interesting and disturbing comparison: Our current global economic crisis, a result of complicated products, hidden prices, and packages designed to hide the risk that is buried in those packages, is clear evidence that people and entities can be sold seriously flawed financial products by businesses intent on selling products at high-profit prices. This is not something at all unique to, or invented by, microfinance.

We have operated under some arguably naïve assumptions in the past decades. We assume that those involved in microfinance are not attracted by profits. We assume that those who come to microfinance have clear commitments to values-based practice, to focusing on the double-bottom line, to balanced decision making that even errs on the side of our clients. In other words, we expected that our decisions and practices would universally be seen by the outside world as responsible, as fair, as ethical.

Sadly, that has not turned out to be the reality. Some of what is called microfinance is now interpreted by the outside world as single-bottom line businesses that maximize profit by loaning to the poor. Are they right? Where is the line between those who have for centuries loaned to the poor for motive of profit and we “social business” alternatives to the moneylenders? The industry has failed to define that line, or even to agree on if such a line exists.

If we are, in fact, guilty of some of us moving too far in the direction of behaving like those who preceded us, there are three possible reasons. Perhaps not all who come into microfinance have their primary inspiration from improving the lives of the poor. Or possibly some of our industry decisions and practices have unintentionally negative consequences. Thirdly, perhaps some of the negative judgments about our behaviors are based on poor interpretation of information. And, very likely, all three of those conditions are true in some complex, mixed combination.

We are now immersed in various efforts to clarify some important issues – Did something go wrong with our original vision? And if so, what went wrong and why? And what can we do about it so that microfinance stays true to its original vision.

THE RATIONALE FOR FINANCIAL SUSTAINABILITY FOR ALL LOAN PRODUCTS

Since the mid-1990’s, it has been widely accepted in microfinance that all financial services should be “sustainable”, or we might say “efficiently delivered and sustainable”. Originally this was communicated as an expectation that all MFIs reach 100% sustainable (i.e., zero-profit), that they must cover all their costs, including hidden subsidies. At first, few or none were within reach of the 100% goal, but within a few years, a growing number reached that level and then began to exceed 100%. This created an interesting situation, because we had all agreed on a *minimum* level of sustainability, but we had not ventured forth into the sensitive discussion of “how much profit is too much profit?”⁶

⁶ In fact, we went for decades without even using the word “profit”, and then almost in the blink of an eye we found MFIs making startling profits.

The rationale for sustainability argued the main points as:⁷

- 1) Donors will get tired of subsidizing credit, and then the services will disappear and the poor will go back to informal sources.
- 2) Donor resources are small, relative to the size of the market for financial services. For all the poor to have equal access to loans, we need to attract in commercial capital, which is in far greater supply than donor funds.
- 3) Demonstrating that the poor are good credit risks, pay back their loans, and are able to pay interest rates that cover costs and generate profit will attract in commercial sources.

The mostly unspoken assumption was that the commercial money coming could be attracted in by showing reasonable profit levels compared to other investment options. There was virtually no discussion about the possibilities of profit-maximizing behavior taking place in near-monopoly conditions or in markets with poor regulations. In other words, we did not anticipate that some practice would attract strongly negative attention from the public and be arguably in contradiction to the social messages marketed by the industry.

To a great degree, much of this comes down to profit motives, as the next sections will argue.

THE IMPLICATIONS OF SUSTAINABLE FINANCIAL SERVICES

In recent years, we are now gently venturing into discussions about acceptable levels of profit. To some degree, these discussions are taking place because the outside world is asking *us* these questions. The recognition of microfinance in the world increased dramatically with the awarding of the Nobel Peace Prize to Grameen Bank and Dr. Muhammed Yunus in October 2006. Just six months later, in April 2007, microfinance made very different headlines, this time with the IPO of Banco Compartamos, in Mexico. The “cash-out” IPO generated over US\$2 billion in profit on a miniscule initial investment of US\$6 million, a return of 300-to-1 on the original investment in the span of just six years. Compartamos’ clients are almost entirely women, and the price paid by those women on their loans at the time of the IPO was well over 100% APR.

Intense dialogue took place inside and outside the microfinance industry. Questions included:

- Is this appropriate and respectable behavior for an industry just awarded the Nobel Peace Prize?
- For an institution that subsidized its start-up phase with millions of dollars in grants, should private parties then reap all the benefits once profits are realized?
- Sustainability may be good, but is “getting rich” acceptable?
- What price should we be charging the poor, and how honest should we be about what that price is?

⁷ Note that the expectations for sustainability are independent from the discussions of organizational structure. An NGO can be sustainable, and may even be more profitable than a for-profit. Discussions about whether for-profits are more efficient, or more motivated to offer better products are independent from the rationale of sustainability.

Coming out of those discussions, the microfinance industry initiated a number of efforts to clarify and define responsible practice. Just a few examples are the SMART Campaign, MicroFinance Transparency, advances with the already-active Social Performance Task Force, and the recent broad-based Seal of Excellence Certification Process. The majority of microfinance conferences held in recent years have focused on the topic of “Responsible Microfinance”, a term that was not used at all in previous decades, but was now at the tip of every tongue.

And as part of this movement came the request from the Micro Credit Summit to write this paper on fair and ethical pricing.

As described previously, this first paper will address topics and examine data from the perspective of the MFI. We will begin by examining what an MFI must charge just to attain financial sustainability. We will begin by assuming that this is a desired goal and that pricing is set to attain zero or modest profit.

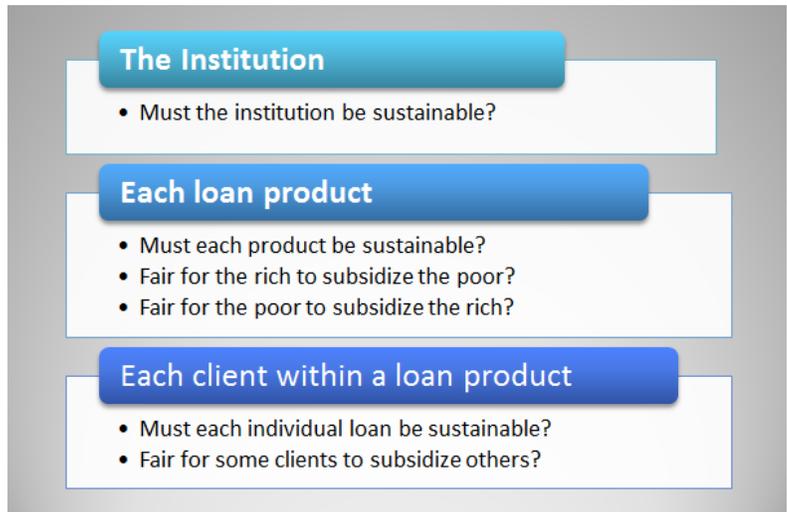
At this high-level analysis, we examine only “Is the institution sustainable?” If it is, we then assume that each of the products of the MFI is priced sustainably, but in fact, that is rarely the case. We will discuss next how some products may make profits, others losses, and some clients generate profits and others losses. As in many businesses, some sales do not cover their costs, and in fact some products are designed as “loss leaders”. In some situations, some products may willfully be subsidized for determined motives.

KEY QUESTIONS – WHAT DOES SUSTAINABILITY REALLY MEAN?

This raises rather important series of questions for us. The responses to these questions may result one way when applying standard business logic, but when the concepts of fairness and ethics are blended in, the responses get much harder.

- **The Institution:** Should an MFI set prices so that it is financially sustainable? Most in the industry say yes.
- **Each Product:** If so, does the expectation that “all financial services must be priced sustainably” mean that the MFI must price *each* product at sustainable prices?
 - Is it acceptable for an MFI to have some loan products generating profits that subsidize other loan products?
 - If so, is it fair to charge higher prices to the middle class to subsidize loans to the poor?
 - Is it fair to charge higher prices to the poor to subsidize loans to the middle class?
- **Each loan within a product:** Within a single loan product, assuming that the loan product is financially sustainable, to what degree should profits made from some clients be generated to cover losses on loans made to other clients?
 - Assuming there are losses on the smallest loans, is it fair to make additional profits off of the larger loans to cover those losses?

- If clients tend to go through a loan progression, is it acceptable to lose money on the first loans to that client, hopefully to be compensated for with profits made off future loans to that same client?
- **Position on Subsidies:** If we reach a position that says subsidizing some loans takes place in each and every MFI, this leads to the conclusion that subsidizing loans to some clients is acceptable. Must that subsidy be covered from profit from other loans to other clients, or is it arguably acceptable to cover the subsidy with income from other sources, such as grants?



Different decisions will result from the mission of an institution, and much depends on the operating context of that MFI.

- Some MFIs may choose to subsidize loans to the very poor by charging higher prices on products to the less poor. What happens if and when competitors offer loans to the less poor at a more competitive price?
- An MFI may choose to work only with the very poor, rather than broaden their market and cross-subsidize. Does that mean they should charge a higher price to the very poor? Or is it justifiable to be subsidized because of their highly targeted market?
- In other words, do policies saying that “sustainability is necessary” find cross-subsidization acceptable (when market conditions allow it) but find external subsidization unacceptable?
- What if an MFI simply works with the less poor, charging the higher price that other MFIs are using to cross-subsidize loans to the poor, but instead of using their profits to subsidize smaller loans, this MFI just takes the profit?

SECTION 6. **ADVANCING ON OUR DETERMINATION OF FAIR AND ETHICAL PRICING**

We have examined how the very smallest loans to the poorest people reach a point where operating costs increase dramatically relative to the loan balance. Microfinance reaches the curve. Formal finance had chosen to stay far away from the curve, but a moderate portion of microfinance has embraced the curve... and often found it painful. Not recognizing the curve ends up clouding analysis of what the industry is doing and it clouds the decisions each of us are making inside of our institutions.

There are very significant cost and price differences among those who are in the not-so-homogenous microfinance industry. This strongly affects market behaviors because we are not one market. This affects how decisions get made inside microfinance institutions. Decision-making rests on the foundation of some array of values and motives. This is true for individuals, it is true in business, and it is certainly true in microfinance.

There is a very familiar list of questions and decisions that each MFI goes thru: Who do we choose to target as our clients? What types of products do we choose to sell to them? How hard do we make our staff work, and what do we pay them? What price do we charge our clients for the products? How transparent are we on that price? And what level of profit do we choose to make?

One may assume that most of these decisions are made with mechanical, objective business logic and decision trees. However, in reality, underlying most of these decisions are the core values of the institution and the core values of those making the decisions. Values are inherent in microfinance, but they are difficult to articulate and difficult to define.

This paper begins to approach the concepts of fairness and ethics. In our personal lives, we all make judgments on if we feel we have been treated fairly and ethically by others. There is some subjectivity to that determination – two people treated the same way by a business may reach different conclusions. Are values therefore too subjective to systematize? Or can we dialogue and reach broad consensus on some set of behaviors that we can then put under the umbrella of “fair and ethical”? There are, in fact, several movements underway to do this to varying degrees, and I’m pleased to see this engagement now taking place.

Now we move into one last discussion area – the relationship of prices to profits.

SHOULD OUR GOAL BE TO *INTEGRATE INTO* THE COMMERCIAL MARKETPLACE OR TO *TRANSFORM* THE COMMERCIAL MARKETPLACE?

In the case of the question raised in the assignment of this paper – What is fair and ethical when it comes to pricing? – we see that the answer is not so simple because there arguably isn’t just “one fair price” in microcredit. If we choose to at least cover the delivery costs of the loan, there is a price curve. When I am asked “What is a fair price?” my answer has always been: “You’re asking the wrong question. There isn’t just

one price, but the price is what generates profit for the MFI, so a more relevant question is ‘What is a fair profit?’”

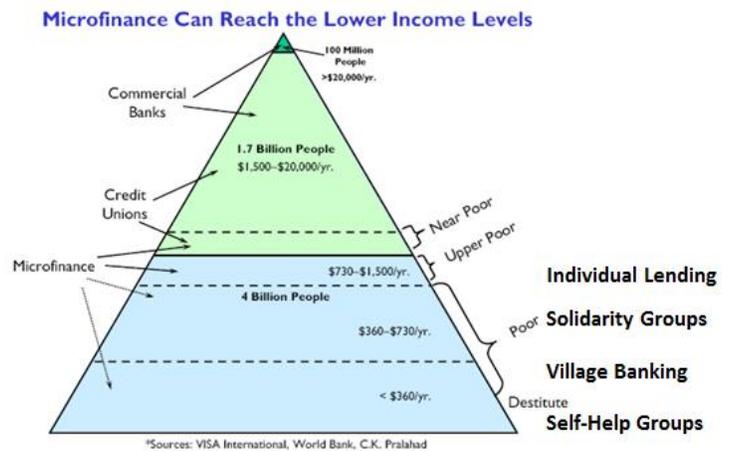
The poor have always had access to credit provided by profit-maximizing lenders. Microfinance argues that it is an alternative to that, but we don’t have any means to distinguish how we are different. I believe we are so tied up in financial ratios that we are missing the obvious. Is it ethical to get rich by lending to the poor? For thousands of years, there has been overwhelming consensus that indeed it is not. Even in the 21st century, when ethics and values are not a common foundation for discussion, any broad-based poll would show a very high proportion of the respondents saying that getting rich off the poor may be legal, it may even be relatively common practice, but for them it does not comfortably fall under the umbrella of “fair and ethical.”

We have seen the pressures that simply targeting *sustainability* applies to us – we need charge dramatically increasing prices on the very smallest loans to the very poorest clients, simply to cover costs. This raises interesting questions about whether it is fair and ethical to require that every segment of the market be expected to pay full costs. Moving beyond the concept of sustainability into profit, we then need to ask “Are there different profit levels that are acceptable depending on the economic level of your clients?”

Higher obligations apply for the bottom of the pyramid

What is unique – and attractive – about microfinance is that the vast majority of our clients are at the bottom of the economic pyramid. We aren’t businesses seeking profit from the top 1.7 billion people in the world. We are businesses that *serve* the bottom 4 billion. Most of our clients live on less than \$2 per day. Society has always respected the difficulties of those living on so little money. Microfinance was created to help increase the income of these people. Microfinance was not created as a means become wealthy by profiting from the poor, but it has become that for a growing portion of our industry. And the profits we gain come from the prices we charge.

The Income Distribution Pyramid



Profit margin is related to the spread chosen

As MFI managers set their prices, they evaluate information from two perspectives. The first is to construct their costs and determine what a minimum price would be to cover those costs. The second is to look at what the “market price” might be. As we have seen, the market price for microfinance is far from clear. Even MFIs

don't fully know what other MFIs are charging. Prices vary considerable, and true prices are really not transparent and therefore not fully known. High profits come not entirely from simply being "efficient" or "large scale" or "keeping customers happy." High profits result from intentionally having a price that considerably exceeds total costs.

We will look briefly at profits in three mature LAC countries, using ROA as a measure of profit because: 1) it is closely correlated to the "profit" line in the previous cost structure figure, and 2) it eliminates the differences in leverage that affect ROE calculations.

Figure 1 shows ROA for 59 MFIs in Peru, a quite large and profitable microfinance market. We saw previously a significant price curve, and also a cost curve. In fact, ROA is quite constant across the continuum of loan sizes. Average ROA is about 3%, and 90% of MFIs are under 5%, considered by some to be a level of "responsible profit". It does stand out that those earning more than 5% are primarily MFIs with the very smallest loans.

Figure 2 shows the same data for Bolivia, another mature and profitable market. This graph introduces scale of the MFI, with the bubble size indicating "number of borrowers". Again, even though Bolivia has a price curve, we see a quite flat ROA, independent of loan size, with only one MFI in the entire country making an ROA greater than 5% (and it happens to be doing so with very small loans).

In both Peru and Bolivia, MFIs aren't generally

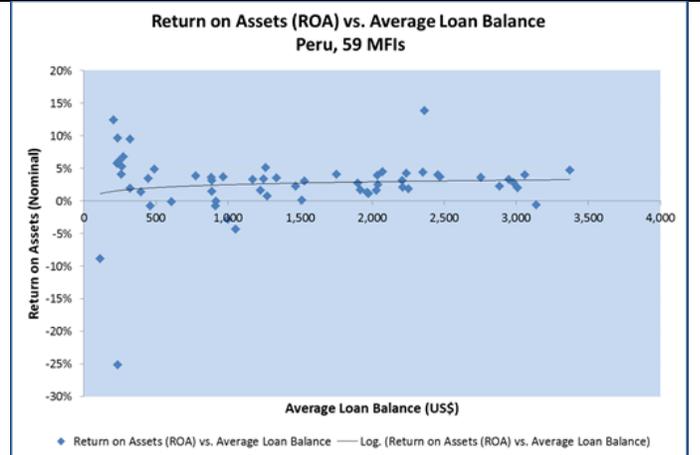


Figure 1

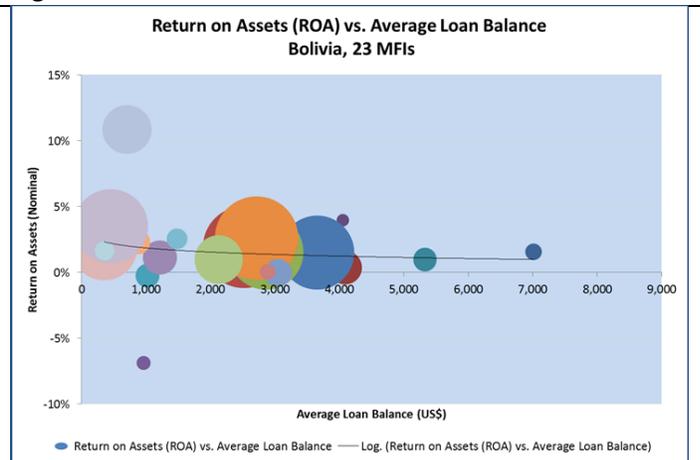


Figure 2

charging a common market price, but are setting prices differently depending on where they are on the loan amount curve.

The final graph is of Mexico. We have seen that the average loan balances are quite small relative to the GNI/capita. Thus most MFIs are on the “steep part of the curve” and we have seen that their operating costs are much higher as a result. Mexican MFIs also have extremely high portfolio yields. Ironically, despite the challenges of very high operating cost ratios, many MFIs in Mexico are extremely profitable. Half of the MFIs earn greater than 5% ROA, with some of the largest in the country are earning ROAs close to 20%, something that simply does not occur in formal commercial finance.

Compartamos is the largest MFI in Mexico and has been widely followed by the industry and the global press, primarily because of their very high profits. They are making those profits in the context of the market we just described. Figure 4 repeats one of the earlier curves, showing operating costs and portfolio yield for Mexican MFIs. The two figures for Compartamos are highlighted with green circles. One can see that Compartamos, with an OCR of 33%, is relatively efficient compared to other MFIs with similar loan balances. Six of those other MFIs have portfolio yields in the range of 50%, the middle cluster of blue dots. Yet other MFIs in Mexico with loans in this size range choose to target portfolio yields in the range of 80%. Compartamos is in this higher cluster. The spread between an OCR of 33% and a portfolio yield of 78% results in an ROA of 17%, making them one of the most profitable MFIs in the world. Their high profits are a result of choosing the higher price.

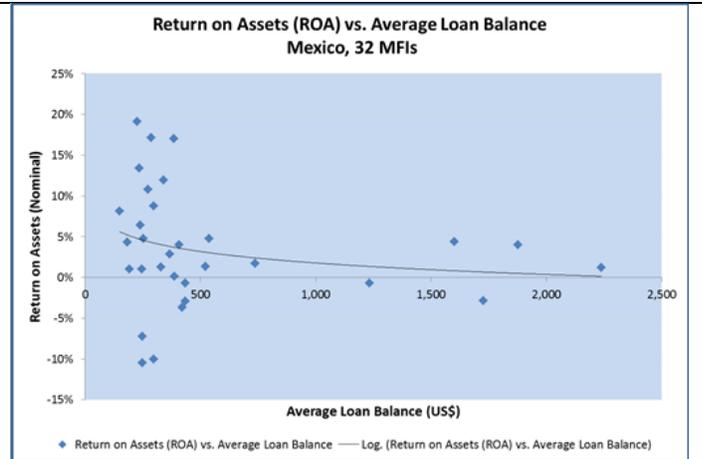


Figure 3

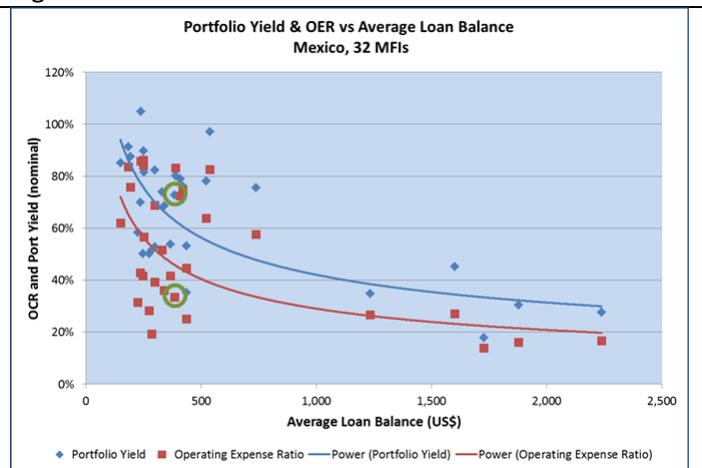


Figure 4

High Profits are a *Choice*

It’s almost too obvious to say, but businesses aren’t *obligated* to make high profits, they *choose* to make high profits. We talk about market forces influencing business decisions, and that is true in some instances, but once your business reaches the point of sustainability (or modest profit), external pressures are off. The choices you make on prices are now your choices. What values do you choose to apply when you make your decisions about the profit levels you target?

The following diagram shows the situation that MFI managers are in. To simplify matters, we consider two MFIs, each selling very similar products, of the same loan amounts (so on the same part of the curve), to the same clients. They operate in an environment where there is no pricing transparency, so they have the choice to hide their price if they wish. MFI “A” is less efficient than MFI “B”. “A” has total costs (operating costs, financial costs, and loan loss) of 30%, whereas “B” is significantly lower, at 20%.

Institution	Total Costs	Price	Profit/Loss	Result	Examination	Decision	Fair?
MFI "A"	30%	25%	-5%	Subsidized	MFI "A" is less efficient than B. It charges a low price and loses money	Voluntary	Yes
	30%	35%	5%	Moderate Profit	MFI "A" is less efficient than B, but chooses to charge a higher price (possibly hidden) in order to generate a moderate profit	Cost pressures	???
MFI "B"	20%	25%	5%	Moderate Profit	MFI "B" is more efficient than A and charges a price to generate a moderate profit. If there were transparent pricing, this would put pressure on "A"	Chooses Fairness	Yes
	20%	35%	15%	Profit-Maximization	MFI "B" chooses to charge a high price (perhaps because "A" is charging a high price) and therefore voluntarily maximizes profit.	Chooses Profit	No

MFI “A” can choose to price its product at 25%, resulting in a loss of 5%. It needs to seek external subsidy to maintain its services. They make this decision to charge a low price voluntarily. They *choose* subsidy. The last column is a subjective judgment about the fairness of the decision. In this case I have stated that this is fair to the client, although others may argue that it is unfair because the MFI may have to close, and clients would no longer have services.

MFI “A” can also choose to charge a price to cover costs and generate moderate profit. In this case, it would need to charge 35%, which may well be higher than the “market rate”, but it does so in order to cover its costs. The decision for the high price can be argued by the MFI to be necessary, an obligation to stay solvent. Is it a “fair” decision to charge a high price to cover your costs when you are not as efficient as others in the market?

MFI “B” is efficient. They can choose to charge 25% and generate a moderate profit of 5%. This would also apply pressure on MFI “A” to possibly get more efficient and possibly to not charge such high prices (if “A” had chosen 35%). Setting prices to cover efficient costs, generate a moderate profit, and put pressure to have market prices of others fall is certainly in the realm of “fair”. MFI “B” *chooses* to be fair.

In the last example, MFI “B” chooses a high price and generates a high profit. They may argue that they are simply charging the market price, high profits are simply a result of good management, and they’ll lower their price when market pressures force prices down. This is a textbook business argument for businesses in perfect markets. Should it be applied to microfinance, where we are operating in very imperfect markets and our clients are at the bottom of the economic pyramid? High profit is a *choice* made by this MFI. Is it fair to choose to get rich off the poor? I argue that it is not.

NEXT STEPS IN DEFINING FAIR AND ETHICAL PRICING

We’ve covered a lot of material that relates to how we currently price our products, how costs vary considerably due to size of loan, and then how prices rise dramatically on the smallest of loans due to pressures put on MFIs by sustainability criteria. We then considered how decisions about profit levels influence pricing decisions. All

of our analysis to this point has been done using “high level” data that only provides aggregate cost and portfolio yield information for a broad array of MFIs.

Our next paper will investigate actual product pricing at a more granular level, combined with interesting new product information – prices by loan size internal to the product, loan term, loan purpose, gender, urban/rural issues, age and scale of institution, and institutional form. Does it appear that MFIs cross-subsidize their products? Do MFIs have some loss-leader products?

The first two papers then look at necessity and practice from the perspective of the institution. The final paper will explore the ability of clients to pay the range of prices charged in microfinance and estimate at what point the majority of clients still benefit from those loans.

With this deeper examination of the issues of pricing from the views of both seller and buyer, we can hopefully come to a more sophisticated determination of what constitutes fair and ethical pricing when lending to the poor.