

## ***Microfinance Interest prices: A Market approach***

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### **Introduction :**

In 1970's microfinance rose as a significant tool to help the poor to establish income-generating business with a promise to snatch millions away from poverty, "a lot of water has flowed under the bridge since then and microfinance became a debatable issue that having enthusiastic supporters and bitter critics.

Yet high prices applied to the clients against their loans represent the most important criticism even it is usually stemmed of the comparison with the prices apply by the commercial banks and neglecting the comparison with any other financing alternatives the poor might seek to have.

It is widely claimed that microfinance institutions charge their clients a high pricing albeit there is no clear standard on which to determine whether it really high or not based on the full spectrum of the financial solutions available in a given country or society.

Almost of such claims always depending on the banking sector prices as a benchmark for comparing to conclude that microfinance which intended invented and introduced to help poor charging them a cost exceeds what the banks afford for their clients.

For the first sight this might consider unfair and unjust for the poor but this stemmed from an emotional perspective doesn't indeed reflect the fact that microfinance industry invested a lot in serving the poor even in many cases without having the feasible return.

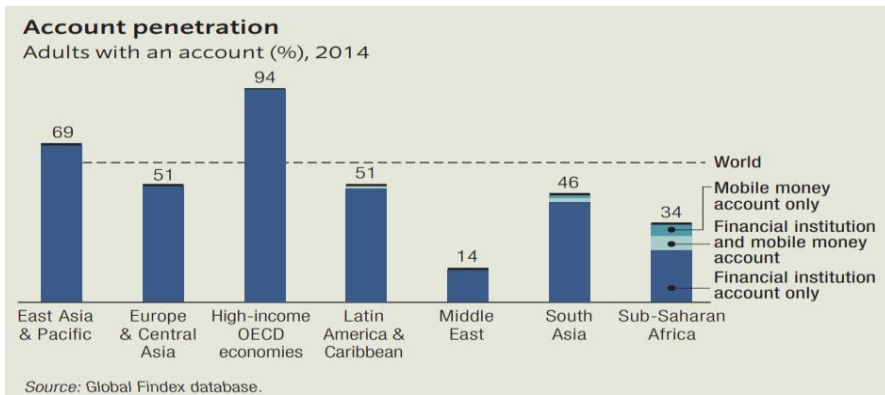
Any argument about the microfinance products pricing will not be productive without an in-depth outlook at the cost components and the applied business models for the microfinance institutions and this study will detail them considering the most possible simplest approaches.

This study will be limited to the companies and institutions that offer only credit services and not to include the institutions that provide saving and deposits to simplify the approach of understanding the pricing issues in microfinance.

### **What is the difference between banks and MFIs?**

MFIs are typically targeted the non-bankable segments in any given country, and bankability rate deeply varied between the advanced and underdeveloped countries, as per the Global

Index Database 2014 <sup>i</sup> the bank accounts penetration exceeds 90% in the OECD area while it is about 30% in the African countries. In MENA region the bankability remained at a very humble level for 14%.



From the very first beginning MFIs are not representing, or at least, did not represent any kind of competitiveness to the banks therefore the comparison seems illogically for the insiders from the microfinance industry but it is acceptable for the social stakeholders especially the media.

To summarize the differences between microfinance institutions and banks the following table shows the major areas of comparison representing the case of India which consider the largest market in the world, moreover the market practice in India has a lot of similarities with the microfinance traditions in the majority of countries where microfinance exists <sup>2</sup>:-

Area	Commercial bank	Micro finance Institution
Focus	Profitability , Market Share , All segment of customer	A sustainable credit system for economically disadvantaged people.
Customer Acquisition	Banks mostly enroll customer through branches.	MFIs have stage-wise strategy-village meetings, formal groups, training of member of groups on financial management and then providing credit-line.
Products	Banks have a basket of retail product that cover savings, credit remittance etc. Credit from banks for BPL-like families is predominantly of INR 25,000 and above; other features are varied rate of interest and varied repayment period.	MFIs specialize in credit .The product is predominantly a graduated credit line with recovery by 50 week EMI.  MFI credit is predominantly an average of INR 15,000 minimum of INR 3,000 to maximum of INR 50,000 (housing loan up to INR 1.25 lacs.)
Procedures	Banks have universally identical procedures as well as for internal management. The procedures are primarily multi-tired, record-oriented and resultantly, lengthy at times.	MFIs have a universally identical procedure for their customer for internal management. Features of the procedure are that these are short and simple for customer and for internal recording but are elaborate on verbal processes with customer
Customer Service Mode	Customer access branches.	MFIs access customer at the location of their inhabitation.
Source of Funds	Combination of owned and Borrowed Capital	MFIs operated on Borrowed fund
Cost of Capital	Average cost of Capital for Bank is 8 percent	Average cost of capital for MFIs is 14 %
Location of Operation	Banks have a formula to determine viability of a branch. This determines the availability of the bank in geographical location.	MFIs operate with families that do not have steady and small credit lines from banks. They do not operate on the basis of geographical location.
Cost of Operation	Banks have mechanism that cross subsidies operating cost of several sets of services and products. Branch viability and business per staff is the strategy area of focus. Cost-income ratio of Banks is about 42 %.	MFIs incur high costs on manpower. Business per staff cannot grow beyond a point because the quality of customer contact is the key to the high repayment rate in micro-credit. MFI operations on customer servicing mechanisms are reflected in cost-income ratio of MFIs that is around 62%
Risk Management	Banks have advanced risk management systems that are imposed as well as self-deserved .The risk management system	MFIs have completely different approach to risk management. This is through continuous contacts with the

	are based in data.	customer and by period re-training of customer and off-field staff. Performance incentives to customer and to field staff are another set of tools for risk management.
Mutual Interest	Banks are interested in MFIs because such credit lines enable banks to achieve the 'priority sector' obligation.	Ownership of MFIs lies with the development professionals and social investor who invest with social objectives.
Ownership	Banks in India 'owned' by government (as shareholder and policy maker), regulator and private investor.	Ownership of MFIs lies with the development professionals and social investors who invest in social objectives.
Nature of Institution	Financial Institution	Service Institution
Financial Goal	Profit maximization	Surplus to sustain

As there is no essential difference in the structure of cost components but it is varied in its weight which decided the price of the services, the following are clarifying the cost elements in microfinance

### Cost of Fund

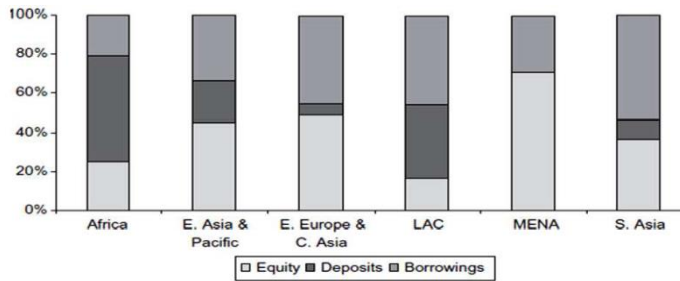
It was a golden age in which microfinance had great opportunities to secure the financial needs throughout donations and subsidized loans from the local developments entities.

In general, microfinance is a part of the international aid allocated from the advanced countries to the underdeveloped once that the global financial crisis affected the appetite of the donors to invest in development and as the MFIs raised the flag of sustainability and commercialization the funding method transformed in favor in loans with lesser interest rates than the provided by the local banks but it contains high probability of

foreign exchange risk should be mitigated by hedging techniques driven the costs in many cases to a very high level.

In many countries nowadays such type of subsidized financing is not available or it scaled down making the MFIs in need for borrowing from the commercial banks with the market rates, but this approach is applicable for the big and stable microfinance institutions but it is not obtainable by the small companies especially the NGOs that well-established have better chance to access to lesser amounts. Consultative Group to Assist the Poor (CGAP) stated that Regulated institutions have some cost advantage even on large commercial loans: lenders see them as safer because they are licensed and supervised by the banking authorities. Also, regulated microlenders on average can absorb larger borrowings, which can reduce their interest and transaction costs<sup>3</sup>.

Cost of fund also varies upon the alternatives of financing in each area and it is highly affected the prices level in any given country, the following chart shows the structure of financing in several areas over the world:



Source: Lafourcade et al. (2006).

Fig. 1. Global distribution of MFI funding sources

## Operational Cost

CGAP defines operational costs to include the costs of implementing the loan activities—personnel compensation, supplies, travel, depreciation of fixed assets, etc. Operating expenses consume the majority of the income of most micro lenders’ loan portfolios, so this component is the largest determinant of the rate the borrowers end up paying<sup>4</sup>.

The CGAP study shown that Declines in operating expenses (i.e. improvements in efficiency) have slowed recently, for the higher costs of its inputs, moreover, when it the MFIs allocate the costs to the loan the smaller loan represents lesser profit and in many cases it will cause losses but it is not easy to get rid from them that the social stakeholders insist on allowing these loans for better access to finance for the poor segments.

MFIs heavily operate in field and hiring a large number (almost from 45 to 50% of the staff in the field as credit

officer) and these required higher costs such as transportation and insurance along with the personnel costs which includes a big portion of incentives.

Working in remote areas where there is no sufficient infrastructure caused higher spending for branching to serve the clients and even the digitization of businesses and utilizing agents is a viable alternative the seed investment seems costly for a lot of MFIs unless they can secure donations to invest in this area from international development agencies.

While the role of management is very marginal in controlling the cost of fund it becomes very crucial for the operational costs and they should focus on both administrative and personnel items.

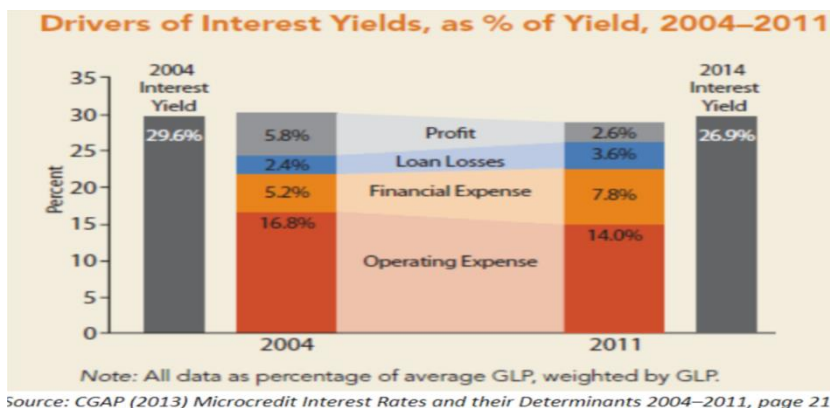
It becomes also challenging to management to secure the financial needs for the development required by the regulatory authorities which started to take the stake during the last decade to set a better business environment, such directions will require high investments in information technology and restructuring its bodies to accommodate audit and risk departments.

However, Operating Expenses Ratio represent a very important efficiency indicator for MFIs that it is calculated by dividing all expenses related to the operations of the institution (including all administrative and salary expenses, depreciation and board fees) by the average gross portfolio<sup>5</sup>.



By considering this ratio average loan size raises as one of the factors driving the profitability and accordingly the sustainability of the institution that in many cases the small loans are not profitable but the MFIs continue to serve such loans under the pressure of the stakeholders.

Wisely and efficiently controlling costs is another requirement by the stakeholders as it widely known that the biggest driver of the cost and prices as well, the following chart is clarified the comparative weight of cost elements<sup>6</sup>:



## Loan Loss Reserve Cost

Despite the fact that MFIs have a high repayment ratios and their clients usually tend to pay their commitments still they are fragile against the changes in macroeconomic factors and social tensions as happened in Egypt, Tunisia and Yemen after the Arab Spring when the crisis of payments raised because the wide base of the

clients who engaged in informal economic activities faced a discontinue period did not allow them to work.

MFI's learned that a conservative loan loss reserves is essential for their businesses and focused on building 2% to 3% out of their portfolios as a provision for bad debts.

MFI's apply the Portfolio at Risk ratio as a major ratio to assess the quality of the portfolio and it based on calculating the principle amount of all loans with unpaid installments to measure the potential for future losses based on the current performance of the portfolio. It is the most widely accepted standard and ratio of portfolio performance in microfinance. It also measures more than the amount collected compared to the amount due (popularly referred to as the Repayment Rate), but the risk that the entire amount outstanding on a late loan will not be repaid. It is important to include the balance of all loans with a payment overdue and not just the amount of principal that is overdue<sup>7</sup>.

This restricted approach based on the assumption that poor and limited clients are not having the same resiliency against the unplanned and unexpected events might affect their microbusinesses and cannot revive with the same flexibility after such conditions.

## **Profit and Sustainability**

Microfinance modern philosophy emphasis on self-sufficiency and growth based on the internal capacities driven by accumulating the returns and reinvest them in the business for this reason even it works using a business like models a lot of MFIs are operated as Non-for-Profit entities and this doesn't attract the traditional investors to engage with injecting financing in MFIs sector.

Promised markets required more investment and therefore the margins requested to match that staying prominent and don't encourage the reduction of the interest rates.

## **Clients Prospect**

It makes no sense for many to figure out how clients who are typically poor accepting this level of prices offered by the microfinance institutions even they can understand why the prices is higher than banks, but it is also important to understand the other alternatives. CGAP paper titled "Are Microcredit Interest Rates Excessive?" found that:

- MFI rates were significantly lower than consumer and credit card rates in most of the 36 countries for which we could find rate indications, and significantly higher than those rates in only a fifth of the countries.

- Based on 34 reports from 21 countries, MFI rates were almost always lower—usually vastly lower—than rates charged by informal lenders.
- MFI rates were typically higher than credit union rates in the 10 countries for which data were found. But in the cases where the credit unions offered a specialized microcredit product, their interest charges tended to be the same as, or higher than, prevailing MFI rates. However, it is hard to make much of this information, not only because the sample size is so small, but also because we know little about the comparability of customers and products<sup>8</sup>.

As money lenders still exist in many places over the world with unpredictable and unreasonable pricing against the tiny loans, the presence of microfinance allow the clients to have the access to a formal source of lending that keeping their dignity and sparing them from illegal treatment.

Microfinance practitioners know also the trick of commercial credit which used by the wholesaler by granting an optional discount for the cash payments while paying the nominal prices when buying the same items on credit.

Retailer are considering a very big portion of the micro entrepreneurs and they always asked for having an amount of cash to enter the cycle of trading with favoring the discounting option as they figure it as the following:-

Assumption: - 10% discount against cash payment while paying the full amount for one month grace period.

- Annualizing cost by the simple approach will lead to 120% on flat basis per annum and with the same amounts for investment.
- Having the fact the micro business owners could have the loan from microfinance institutions for 20% flat (36% based on effective rate approach) will make a save of one sixth of the cost of the commercial credit.
- Accumulating and reinvest the excesses of return will secure additional income to the business.

### **Price Transparency in Microfinance**

Yet the prices of microfinance products stay under the critics of the stakeholder claiming more transparency in calculating interest rates and announce it in the proper approach using the declining approach rather than the flat approach which deludes the clients they are paying less while they are actually cannot compare what they are paying with what they ought to pay if they target the bank, noting the contradiction that they are non-bankable clients and not likely to become in the short and middle term.

MFT transparency found that declining approach is better approach for the clients for the following reasons:

- It is an accurate reflection of the cost of borrowing. There is no theoretical basis for the flat method. It does not make sense for a borrower to pay interest on money they do not have.
- It is closer to the actual price. A transparently communicated price is one that most closely matches the overall cost of borrowing when all charges are considered. Compared to the declining balance, the flat calculation method is far from this. Prices calculated using flat interest payments sound much lower than those using declining balance interest rates. However, the declining balance calculation method is more transparent because the figure communicated to the client is closer to the figure representing the actual percentage of the loan amount paid in interest.
- Using one method, borrowers can compare prices. It is very difficult for borrowers to compare a loan with a 15% flat interest rate to a 25% declining balance rate. If all institutions used the same calculation method then borrowers would be able to make more informed decisions.
- It enables price competition based on transparency. When borrowers are able to compare prices then institutions can compete more effectively, potentially resulting in better services and ultimately lower rates. Institutions can also make smarter price-setting decisions.”<sup>9</sup>.

The Smart Campaign which represents several industry leaders stressed on better handling of transparency of the microfinance products, moreover, central banks and the regulatory bodies started to issue restricted guidelines for this purpose.

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