

# Zoom microfinance

## In favour of fair and transparent interest rates in Microfinance

How to set an interest rate

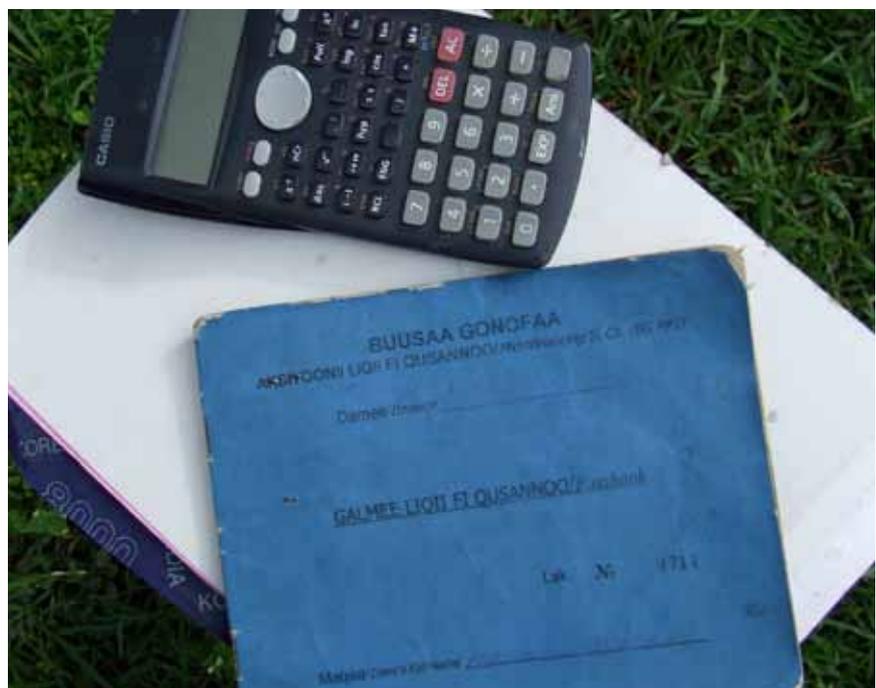
How to set the lowest possible rate

« Access to services is the most important thing... »

Should we cap the rate?

Transparent rates, please.

Specific constraints in rural areas



A credit agent's tools at Buusaa Gonofaa, in Ethiopia.

© SOS Faim - M. Lefebvre

**The question of interest rates is of central importance to the microfinance industry. Interest rates continue to fuel debate and controversy, as they constitute the largest component of the price paid by clients for financial services which are meant to be accessible and suited to low income populations.**

The need for a transparent and acceptable rate of interest (suitable to a given economic activity) has been reinforced by a new concern with customer protection in microfinance. This theme emerged in response to various crises<sup>1</sup> experienced by the sector in countries as diverse as Bolivia, Nicaragua, India, Morocco and Benin. These crises were often related to over-supply in some markets, with borrowers subject to the debt trap or ponzi type schemes.

So, how are microfinance institution interest rate levels justified?

In principle, an interest rate is the best possible service for which a variety of costs are incurred by the MFI.

1: "Au-delà de la crise", Défis Sud 102, pages 7-9.

## How to set an interest rate

Each of these costs that the rate consists of can be measured to a greater or lesser extent, depending on type:

- ☛ **operating costs** (including personnel costs) depend in large part on choices made by the MFI (often called the “lifestyle” of the MFI). These overheads are usually in the range of 10% to 25%. This is the cost factor that generally weighs heaviest in determining interest rates: 62% (source: Microfinance Hub<sup>2</sup>). The MFI has to be efficient while offering attractive conditions to its employees;

- ☛ **costs related to loan losses** are also relatively controllable (except in cases of widespread degradation in the lending environment). Preferably, this rate should range between 1% and 2% in a healthy financial entity;

- ☛ **the margin on the transaction** (profit) can also be managed by the MFI and reflects a choice that is ultimately political. It is interesting to see how profits are employed, especially, given microfinance’s supposed development objectives. This is not to condemn profit generation. Indeed, profits allow an institution to build up capital and invest in new initiatives such as greater geographic outreach or new product development. However, certain figures raise questions. The top ten percent most profitable MFIs have an average annual return on capital of 34%. The Mexican MFI Compartamos recently had a return on capital of 56%. To achieve this, it charged its customers annual interest of 85%. If it had opted for a more reasonable (but still significant) 15% return, the interest rate charged to customers could have come down from 85% to 56%.

- ☛ **Costs associated with borrowing** (savings, national or international refinancing) are controllable only to a certain extent. There is in fact a growing market in refinancing services. Drawing upon client savings is not always an option (depending on regulations governing the MFI and its legal form). This is discussed further on in more depth. According to Microfinance Hub, the cost of loan funds accounts for 23% of the interest rate charged;

- ☛ Finally, accounting for inflation’s impact on the MFI.

  
**The top ten percent most profitable MFIs have an average annual return on capital of 34%**  


As shown, the rate offered is usually the result of tensions between a triangle of actors who, in principle, have conflicting interests: customers who want the best service at the lowest cost, employees who want to be well remunerated and holders of capital who want favourable results. Note that in some MFIs, such as co-operatives, some of the same people may be found in several of these categories of actors.

## How to offer the most reasonable rates possible?

According to E. Parent (Proparco)<sup>3</sup>, four levers are key:

- ☛ A good return on available resources: that means at least 70% of total assets should be allocated to credit transactions which are the life blood of the MFI business;
- ☛ A reasonable quality loan portfolio: PAR30 below 3%.
- ☛ Maximum reduction in cost of financial resources, including an emphasis on deposits (cheaper than refinancing) and optimal use of the “debt/equity” leverage effect.
- ☛ Control over operating expenses by an efficient organization.

We asked around twenty microfinance practitioners for their views on the subject. The responses received chimed with the views put forward by Proparco:

### Operating cost control

Controlling operating costs, which weigh heaviest in setting the rate, is one of the first solutions put forward. In concrete terms, this involves:

- ☛ raising the professional standards of all staff;
- ☛ the loan process, “a decision-making process which is as transparent as possible to all involved, is clearly communicated to customers and keeps bureaucracy to a minimum”;
- ☛ strict and permanent budgetary control;
- ☛ an effective information management system which enables problems to be addressed quickly.

2 : “10 Determinants of Interest Rates in Microfinance”, <http://microfinancehub.com>

3 : Parent, Elodie. September 2009. “Striking a balance between affordable rates and satisfactory profitability in microfinance institutions”, Proparco.



© SOS Farm-A, Rennes

*The independence of rural women in Peru is contingent on access to credit.*

### The cost of financial resources

Mutual or cooperative respondents point out the advantages of using members' deposits. Savings (both collecting and remunerating these) is indeed considered cheaper than other sources of funds. A well run institution can achieve costs of around 4%. Kafo Jiginew, the leading MFI in Mali, collects savings from members at a cost that ranges between 4.75% and 5%. According to interviewees, there are other advantages to using savings. In the first instance, a significant demand is being met; micro finance should not be reduced to the credit side alone. There is also the advantage of having stable resources, even in the most common case where savings are deposited on sight.

Harbu (Ethiopia), which was created as a credit-oriented MFI, has realised the importance of savings: they are not only a relatively inexpensive source of funds for their lending activities but they serve as insurance for

the MFI. Serious savers generally make more committed customers. This evolution in the business's focus has not been achieved without difficulty as it has required a change of mentality amongst the loan officers.

If refinancing is the option of choice, one interviewee argued that having guarantees would help in negotiating a more attractive rate, as these reduced lender risk.

### Limiting loan losses

Several practitioners emphasise how a good management information system (MIS) enables them to be much more responsive. According to an officer at Kafo Jiginew "high losses often result in higher overhead costs and are indicative of poor management and governance. At home, daily monitoring is performed every morning, which can sound the alarm if necessary, and, for example, focus on recoveries and slow loan issuance."

## Harbu's approach to minimising costs:

*For Harbu, there are three aspects to cost minimization, in order of priority, they are: improving productivity, controlling expenditure and responding to customer demand.*

*Greater productivity is achieved by incentivising agents, investing in their training, greater use of technology or through agreements with other financial institutions to ensure they get as close as possible to customers.*

*Expenditure control is encouraged through various measures such as customer loyalty, a savings culture, decentralization of decisions at the agency level, the strengthening of internal control, strict management of cash.*

*And finally, being customer focused, which includes providing quick turnaround times on loan applications (by collecting only essential information), and suitable products that are client-centred (collection of repayments and savings in a location that is central from the client's perspective, for example, in markets).*

## “Access to services is what is most important”

The following point is often argued in the debate on interest rates in microfinance: “what matters most is the opportunity of access to credit services rather than the cost of the services, as such”. Does that mean that interest rates are not that important in the end? Various studies have demonstrated the low elasticity of demand for credit relative to interest rates. The same argument of opportunity of access to the service is also often used to justify the very low remuneration rates on deposits.

In a recent CGAP Focus Note<sup>4</sup>, microfinance services are cited as being so valuable to customers that they are generally willing to pay high interest rates on loans and accept a minimum or no return on savings.

It is clear that this debate must take into account the importance of interest rates to the activity in question: the internal rate of return of an agricultural production activity is not at all comparable with that of some small business or micro industry. Ignoring this parameter can

produce disastrous results for the client. In agriculture, as margins are lower, the MFI must adjust its rates. Several ways are possible: working at a loss in the agricultural sector by subsidising it through activities in urban areas, for example, or finding suitable sources of funds – in other words at a subsidised cost – which raises question about the sustainability of the service.

## Should we cap the rate?

The question of the appropriateness of setting a maximum interest rate is another facet of this same problem. According to Gonzalez-Vega<sup>5</sup>, such a limitation would be counterproductive: the obligation to implement lowered interest rates may lead institutions to focus on fewer, more profitable clients, who have greater influence. In turn, institutions would increase average loan size in order to reduce their costs and would thus exclude the poorest.

A CGAP publication on the impact of interest rate caps in microfinance<sup>6</sup> builds on the same subject: despite good intentions, the fixing of interest rate caps is generally detrimental to the poor because it makes the creation of MFIs more difficult and problematic to existing MFIs. In countries where these limits exist, MFIs withdraw from the market, grow more slowly, are less transparent in terms of costs and reduce their activities in rural or other high cost areas. The poor are no longer served and informal moneylenders return to markets. The note cites the cases of West Africa, South Africa and Nicaragua.

In one of its publications, the Asian Development Bank<sup>7</sup> identifies a further constraint to capping ceiling rates: it encourages not only larger loans but also shorter term ones because inflation makes loans riskier longer term in this context. In addition, the cap may inflate demand and create an artificial market.

### But what do the practitioners who were consulted think?

Opinions are fairly divided between supporters of an uncapped interest rate (with the arguments noted above) and supporters of a capped rate with safeguard mecha-

5 : Gonzalez-Vega, Claudio. «Interest rate restrictions and income distribution», quoted in «Fair interest rates when lending to the poor - Ethics and Economics», Marek Hudon, 2007.

6 : Occasional Paper No. 9, «Interest rate ceilings and microfinance: the story so far», September 2004. CGAP.

7 : Fernando, Nimal A. May 2006, «Understanding and dealing with high interest rates on microcredit», Asian Development Bank.

4 : Rosenberg, Richard. 2010. “Does Microcredit Really Help Poor People?” Focus Note 59. Washington, D.C.: CGAP.



© SDB Faïm-M.Lefebvre

Rural branches are rarely computerised (here inside a branch of U-BTEC in Burkina Faso).

## Interest payment

*Another interesting aspect of this issue arises when micro entrepreneurs' interest payment expense is considered within the overall context of their revenues and expenditures. Castello, Stearns and Christen present an analysis of this kind based on a sample of Chilean, Colombian and Dominican borrowers. These borrowers paid relatively high monthly rates (6.3% per month on average). However, their interest rate payments represented only a tiny proportion of their overall costs (between 0.4 and 3.4%).»*

*Extract from the CGAP special study «Microcredit Interest Rates» (French only), January 1997.*

nisms to avoid the disadvantages of a straightforward cap.

For Ciderural (Peru), "it is possible that an MFI charges high interest rates because it provides customers with associated capacity-building services and it is also possible that the rate reflects a high cost of financial resources to the MFI. We should instead look at the MFI's profit margin and operating costs and see if they sit well with the organisation's mission and the reality of the context."

Finrural (Bolivia) believes that "rate regulation should take into consideration that there are different institutions in the market, with different operating costs, that serving a customer in the city centre is fundamentally different to doing so in a rural area, that a salaried customer doesn't have the same risk profile as a small rural pro-

ducer, that the lending methodology used, including the guarantee required, also changes the level of risk.”

For Renaca (Benin), “a cap on interest rates without specific support (access to lower cost resources, operating subsidies, etc.) to help MFIs manage the potential shortfall it would create, would certainly create imbalances whose consequences might hinder the viability, especially of small MFIs or those that have not yet achieved self-sufficiency.

Any rate cap should be determined (by the monetary authorities) for the principal purpose of eliminating usury rather than to cut costs to customers. Such an initiative should concern itself foremost with the quality of upstream resources (cost of funds, duration, payment terms, etc.) used by MFIs in order to assess the costs involved and set a threshold that does not jeopardize the profitability of the MFI’s operations “.

The MFI network, Alafia (Benin), returns to the subject of moneylenders, “as the interest rates are not a problem for customers, there is no justification for limiting interest rates. We should stop comparing MFIs to commercial banks, they are not in the same market, MFIs operate in the moneylender market; so MFIs should be compared to moneylenders, you will see there is a clear difference in terms of interest rates. If you do away with the MFIs, their customers will not turn to banks, but rather to moneylenders. This comparison of MFIs to moneylenders is therefore justified. Protecting the consumer is not synonymous with capping interest rates. The Smart Campaign has published the principles of client protection. One of these principles is transparency of prices and terms and responsible pricing, requiring institutions to provide quality services, which are beneficial to customers, at competitive prices. A transparent microfinance market with financially educated clients is a sure way to lower interest rates.”

## Transparent rates

This point leads naturally to the importance of the issue of interest rate transparency.

There is almost complete unanimity on the panel of institutions contacted to say that transparency levels are still insufficient and need improvement. The commissions, flat rates, administrative fees charged to borrowers

are all criticised by the MFIs themselves. Do they question their own practices or do they believe rather that it is their colleagues who have questionable practices? We are not in a position to answer this question.

Several explanations are suggested, for example, CI-Derural (Peru) say “90% of clients from disadvantaged areas have no financial knowledge base, making many MFIs less than transparent to their clients, whether voluntarily or involuntarily.”

Finrural (Bolivia) says “despite the efforts of regulatory bodies and MFIs themselves, there remains much to do, since the customer is not able to discriminate for example between variable rates and fixed rates and therefore does not take this into account when choosing a financial entity. We must therefore create permanent customer focused financial education mechanisms run by independent entities.”

The importance of financial education surfaces in several reactions and has also become a priority for more and more actors involved in supporting the sector. The EU-ACP 2011-2014 microfinance programme has made this one of its priorities.

The Alafia network (Benin) also shines a light on MFI training: “Few MFIs ensure that clients have access to comprehensive information, in plain language, which does not cause confusion and that customers are able to understand. Communication about prices and terms is not yet sufficiently clear and staff are not adequately trained to effectively communicate with all their customers to ensure that they understand the product, the terms of the contract, their rights and obligations. Communication techniques used do not make up for limitations related to the literacy level of clients. At the vast majority of MFIs clients are not sufficiently informed of the prices and terms of all the financial products before the sale is concluded, including interest rates, insurance premiums, minimum credit balances, all fees, penalties, related products, third party costs, and changes that may occur over time.”

Genuine rate transparency is increasingly seen as a minimum condition of a competitive market. Combined with measures to protect customers and provide them with financial education, real competition is supposed to develop, leading to borrowers being offered lower rates. The market for micro finance would then become a market like any other in line with a ‘liberal’ view of development.



## Specific constraints in rural areas

Is this approach suitable in rural areas, given that many industry observers agree that rural microfinance – especially applied to agriculture – has seen little if any progress? The controversial issue of interest rate subsidies seems to have led to a broad consensus against any form of distortion of the “market” (if one can speak of a market in many cases). Governments often do not have the means to finance this type of mechanism, even in some cases where it is envisaged by law. Thus Article 125 of the Agricultural Orientation Law in Mali says: “interest subsidies intended to intensify and modernise agriculture may be granted to farmers by the state in particular to finance acquisition of equipment, to promote the development of targeted sectors or special production zones.”

The search for solutions to the question of access is moving in the direction of costs reduction (in order to reflect this in pricing), so as to make financing affordable, especially for small-holder farmers focused on food production<sup>8</sup>.

### Some of the ideas most often considered are:

- ☛ certain funding distribution models can help reduce transaction costs in remote rural areas, for example, using solidarity groups or financial intermediation by cooperatives or farmers’ organisations;
- ☛ directing savings that are mobilised in rural areas towards lending to farmers for productive purposes, combined with technical assistance;
- ☛ using technology: the use of mobile phones as a part of the solution to the issue of cost in order to serve rural areas: it is estimated that a transaction by phone costs 5 cents on the dollar while the same operation in a rural branch will cost about 1.5 dollars<sup>9</sup>. This inexpensive solution to implementation, however, requires expensive infrastructure and users may require a long time to adapt.

<sup>8</sup> : Access to export crop-related finance is easier and often integrated into the value chain of a product.

<sup>9</sup> : Quoted in «Cracking the Nut - Overcoming Barriers to Rural and Agricultural Finance - Lessons from the 2011 Conference».

Assisting producer groups to market (securing sales contracts at negotiated prices).

## Conclusion

The issue of interest rates, particularly for rural areas, is a complex subject which cannot be covered in only a few pages. Many factors are at play, as we have seen, which micro finance institutions control to a greater or lesser degree. The aim of this edition of Zoom Microfinance was to revisit the justification for interest rates levels and in particular give actors from the South a voice on the subject.

The fact remains that a large scale shift in microfinance towards the commercial sector (even when ethical) has disseminated market logic extensively such that it is reflected in widely varying costs of financial services to MFI clients and members.

The question of rates, especially in rural areas remains a concern, especially when comparing the cost of the activity being funded with its profitability. Clearly, a willingness to develop proactive agricultural policies (as many Northern countries have done) and to endow them with sufficient funding is one way of implementing sustainable structural funding mechanisms for agriculture and livestock. Otherwise, there is reason to believe that rural finance will continue to be marginalised.



This issue of *Zoom Microfinance* was written by Marc Mees, Head of SOS Faim's Partner Support Service, together with the following partners:

Benin: **Alafia, Renaca** - Burkina: **B-TEC, Prodia** - Mali: **KAFO Jiginew, Sexagon**  
Niger: **Mooriben** - Senegal: **PDIF, FONGS-Finrural** - DRC: **Coopec Mayumbe, GAMF**  
Cameroon: **Nowefoch, MC<sup>2</sup> Bamenda** - Ethiopia: **Harbu, SFPI** - Peru: **COOP. La Florida, Mide, Ciderural, COOP. Tikari** - Bolivia: **Finrural, Fincafe, Prorural, Coraca Protal**  
Ecuador: **Cepesiu**

## SOS Faim and microfinance

For several years, SOS Faim has supported different microfinance institutions in Africa and Latin America. As with all development tools, we have to analyse the aims, models and implementation conditions of aid to farmers organisations. It is with this purpose in mind that SOS Faim publishes *Zoom Microfinance*.

This publication is available for download in French, English and Spanish on SOS Faim's website: [www.sosfaim.org](http://www.sosfaim.org).

SOS Faim is a member of the European Microfinance Platform [e-MFP] and the Luxembourg Round Table on Microfinance (LRTM).

Apart from *Zoom Microfinance*, SOS Faim publishes another newsletter, *Farming Dynamics*, which deals with the development challenges farmers' organisations face. This publication is also available for download in French and Spanish. SOS Faim's website: [www.sosfaim.org](http://www.sosfaim.org).

Editor: Freddy Destrait, rue aux Laines 4, B-1000 Brussels (Belgium).

Coordinator: Marine Lefebvre

Graphic design: Marmelade Studio

*Zoom Microfinance* is printed on recycled paper

## SOS Faim – Agir avec le Sud

Rue aux Laines, 4 B - B-1000 Brussels - Belgium

Phone 32-(0)2-511.22.38 Fax 32-(0)2-514.47.77

E-mail [info.be@sosfaim.org](mailto:info.be@sosfaim.org)

## SOS Faim – Action pour le développement

88, rue Victor Hugo L-4141 Esch-sur-Alzette - Luxembourg

Phone 352-49.09.96 Fax 352-49.09.96.28

E-mail [info-luxembourg@sosfaim.org](mailto:info-luxembourg@sosfaim.org)

Web site **[www.sosfaim.org](http://www.sosfaim.org)**

*Zoom Microfinance* is produced with support from the Belgian Directorate-General for Development Cooperation and the Ministry of Foreign Affairs in Luxembourg.

## Recent issues of *Zoom Microfinance* have dealt with the following topics:

### n° 34

The support system for key growth sectors of the Cameroonian farmers' organization - Nowefor

### n° 33

The role of Harbu Microfinance in the development of the soybean value-chain (Oromia region, Ethiopia)

### n° 32

Farmer bank, farmer terms

### n° 31

PAIDEK, an MFI resistant to crises

### n° 30

From «classic» microcredit to a regional solidarity-based approach: the FATICK integrated development programme, Senegal (FIDP)

### n° 29

The LOS ANDES cooperative: solidarity-based finance for rural development

### n° 28

Refinancing guarantees: calculated risks on behalf of small rural farmers