

Microcredit Interest Rates: Determination and Issues

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ADB

“If you lend money to one of my people among you who is needy, do not be like the moneylender; charge him no interest.”

**The Book of Exodus (Old Testament)
Chapter 22, verse 25**

“It is not because of the benevolence of the baker that we eat fresh bread every morning but because of his desire to make money.”

Adam Smith

“.....If you lend to the poor, do it without concern for profit, so that they can have the maximum help in climbing out of poverty. Once they’ve completed the climb, then treat them like every other customer—but not till then.”

**Professor Muhammad Yunus
Nobel Laureate, 2006.**

Outline

Part I

- Introduction: Objectives and Questions
- Determining Cost Covering Interest Rates
- Cost Recovery Rate Formula

Part II

- Some Key issues
- Conclusions

Part I

Introduction: Objectives and Questions

- We try to achieve a number of objectives
 - Get a better handle on interest rate determination
 - Explain concepts involved in interest rate determination
 - Discuss general issues and concerns about cost recovery interest rates

Part I

Introduction: Objectives and Questions (Cont'd...)

- Ask three basic questions
 - Is this tool (formula) useful?
 - Does the tool help us think through how to bring down high rates?
 - Can interest rate determination be reduced to a rigid formula?

Determining Cost Covering Interest Rates

- Basic rationale is simple and clear
- But interest rate debate is long standing
- Widely different views
- Comparison difficulties: quoted rates may differ from actual rates
- Many misconceptions

Cost Recovery Rate Formula

$$R = \frac{AE + LL + CF + K - II}{1 - LL}$$

Where:

R	=	rate of interest
AE	=	administrative expenses
LL	=	loan losses
CF	=	cost of funds
K	=	capitalization rate
II	=	investment income

Some Basic Points

- Data comes from balance sheets and income statements (including projections)
- But adjustments are needed
- Each variable: as a decimal fraction of average outstanding loan portfolio

Administrative Expenses (AE)

- Adjustments for subsidies
- For inadequacy of loan loss provisions
 - Are they adequate?
 - If not, adjust to come to the required level

Loan Loss (LL) Ratio

- Reflects loans that must be written off
- Different from delinquency rate

Cost of Funds (CF)

- Cost of borrowings...adjustments needed
- Cost of deposits...at what rate?
- Cost of equity...need adjustments for inflation. Why?
 - Inflation erodes the value of equity
 - Must use a realistic inflation rate

Capitalization Rate (K)

- Growth needs to be funded
- Higher growth...higher amount of funds
- Internally generated profits is one way to get such funds
 - If target portfolio growth is 36%; and
 - Projected portfolio/equity ratio is 3.0
 - $K = 0.36/3.0 = 0.12$

Computation of the Rate

- **Assume**

- **AE = 0.21**

- **LL = 0.02**

- **CF = 0.18**

- **K = 0.12, and II = 0.01**

- **Then "R" comes out as: 0.53 (or 53%)**

- **$(0.18+0.02+0.21+0.12 - 0.01) / 1.0 - 0.02$**

Part II

Some Key Issues in Microcredit Interest Rates

- Is cost plus approach the only way?
- Do microcredit interest rates have to be necessarily high?
- Can the poor afford high interest rates?
- What can be done to bring down the rates?

Other Approaches to Pricing

- Japanese approach to pricing
 - Design products to meet a pre-determined price point
 - This approach is particularly relevant for microcredit for the poor
 - When you start this way the whole process changes fundamentally

Other Approaches to Pricing (cont'd...)

- Question becomes: how do we produce and deliver loan product "X" to sell at price point "p"? [not, what price we should charge for our loan product "X"?)
- \$100 laptop; \$6,000 car are non-credit examples

What About Borrowers Welfare?

- Insights from Compartamos IPO in Mexico
- But policies should not be formulated on the basis of exceptional cases

Do Interest Rates Have to be Necessary High?

- What is the simple answer to this question?
- High rates are normally justified by high costs
 - High cost structure is not an inherent characteristic
 - Lack of emphasis on costs
 - Lack of emphasis on low-cost business models
 - Pricing strategy must be fully integrated into the organizational design and product development

Do Interest Rates Have to be Necessary High? (cont'd...)

- Must also think of “political sustainability” of interest rates
- “Adverse selection” and “moral hazard” problems.

Can the Poor Afford High Interest Rates?

- Conventional justification: they borrow from informal markets at higher rates
- Yes, it is true. But, the full story is more complex
- If returns on investments are high...
- But such opportunities may be limited
- There are many who cannot pay high rates
- Poor need credit for social investments/consumption/emergencies

What Can MFIs do to Reduce High Interest Rates?

- Organizational changes – remove fat (not meat)
- Re-examine your business model and improve
- Partnerships can help
- Move away from exclusive focus. Controversial issue...
- Measures to reduce operating costs
- Improve risk management

What Can Policymakers Do?

- Ceilings are not the answer
- Sectoral cap on ROA? (Vijay Mahajan of BASIX)
- Improve policy environment (minimize policy risks)
- Make markets more competitive
- Develop financial infrastructure and promote financial transparency
- Measures for consumer protection and improved transparency

Conclusions

- We need a fundamental shift in the way we think about microcredit interest rates
- Must admit high rates deny access to some segments of the poor
- Rates must be brought down while ensuring sustainability
- Both financial and political sustainability are important
- Strategic approach to pricing is needed

Thank you

Selected Readings

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