Microfinance works

Are interest rates required by Microfinance Institutions justifiable?

responsAbility's Discussion Papers
responsAbility publishes Discussion Papers on a regular basis. They are aimed at providing state-of-the-art information on actual topics relevant to microfinance and to our clients. Their aim is to support the ongoing discussion with our partners, clients and stakeholders with the ultimate objective of developing a common understanding of key issues in the field.

Investors are often surprised by the seemingly high interest rates for small loans required by Microfinance Institutions (MFIs) in developing countries. Typical interest rates are in the range of 2 to 4% per month, which can lead to annualised interest rates in the range of 20 to 80%, depending on the scheme.

In this Discussion Paper we explore why such interest rates are justified and needed for microfinance to work in an economically sustainable way. We also show that clients are able and willing to pay such rates and point out to the fact that microfinance is a tool that should be used only for certain types of clients in developing countries.

What are microcredits and how do they work?
Microfinance Institutions (MFIs) provide poor families with very small loans (so-called microcredits, typically in the range of hundred to a few hundred US dollars) to help them engage in productive activities or grow their small businesses. Over time, *microfinance has come to include a broader range of services* (credit, savings, insurance, etc.) as it became clear that the poor and the very poor who lack access to traditional financial institutions require a variety of financial services.

Microcredit came to prominence in the 1980s, although early experiments date back 30 years in Bangladesh, Brazil and other countries. Microcredit has largely been a private (non-profit) sector initiative that focuses on providing standardized credit products at interest rates that should cover the costs of credit delivery and guarantee a sustainable business without relying on subsidies.

Why are monthly rates in the range of 2 to 4% justifiable?
Providing financial services to poor people is quite expensive, especially in relation to the size of the transactions involved. This is one of the most important reasons why banks don't usually provide small loans.

A US$100 loan, for example, requires the same personnel and re-sources as a $1,000 one thus increasing per unit transaction costs. Loan officers must visit the client's home or place of work, evaluate creditworthiness on the basis of interviews with the client's family and references, and in many cases, visit their clients to reinforce the repayment culture. It can easily cost $25 to make a microloan. In absolute terms this is easily understandable but in relative terms it might represent 25% of the value of the loan, and force the institution to charge a seemingly high rate of interest to cover the cost of its loan administration.

Why clients are willing and able to pay these rates
Practical evidence shows that clients are willing to pay the higher interest rates necessary to assure long term access to credit. They recognize that their alternatives—even higher interest rates in the informal sector (moneylenders, etc.) or simply no

access to credit—are much less attractive for them.

Interest rates in the informal sector can be as high as 20 percent per day among some urban market vendors. Many of the economic activities in which the poor engage are relatively low return on labor, and access to liquidity and capital can enable the poor to obtain significantly higher re-turns, or to take advantage of economic opportunities. The return received on such investments is often many times greater than the interest rate charged. In economic terms we could say that poor people previously without access to capital operate in a very steep part of the utility curve.

This fact actually makes microfinance economically viable and is one of the core drivers of what we expect will be a rapid expansion of private-sector led microfinance initiatives in the next years.

Example: basket-seller

A woman in Zambia sells hand-woven baskets. As a widow she must provide for a family of seven – from children to grandparents – on her own.
At the moment she has no way of saving or borrowing money. This means she has to wait until she has sold two-thirds of her fifteen baskets before going to the next town to buy new ones with the proceeds. Every three days she has to close her stall for a day, because the town is half a day's walk away.
She would like to rent a small store-room on the market square. This would mean she could offer a larger selection and would only have to make the journey every two weeks. She has worked out that she would have to borrow the equivalent of USD 150 for four months to cover the first rent payments and the initial consignment of baskets. The local money-lenders at the market would be prepared to lend her this amount at interest of 10% per day(!).
A local microfinance institution (MFI) offers her the necessary capital for 4% a month. She accepts the offer. Because she can now sell a larger and more varied range of baskets, her monthly income grows from USD 50 to USD 110. Of this, USD 6 a month goes to pay interest to the MFI and to repay the principal in instalments. Given the increase in her income, she views this as a small price to pay. Now she travels to her supplier twice a month, and can afford to take a ride in a truck. This saves her two days' travelling a week. The microcredit has enabled her to boost sales and thus her income.

Why microfinance should be used only for certain types of clients

It is important to realise that *microfinance is just one of many private and public sector instruments* to support development in poor countries. Each instrument should be focused on those situations in which it is most effective. We have pointed out that for microcredit to be economically sustainable and thereby reach a large number of clients it needs to price loans in a realistic way. Microcredit is only useful in certain situations, and for certain types of clients.

Microcredit serves best those who have identified an economic opportunity and who are in a position to capitalize on that opportunity if they are provided with a small amount of cash. Thus, those poor who work in stable or growing economies, who have demonstrated an ability to undertake the proposed activities in an entrepreneurial way, and who have demonstrated a commitment to repay their debts are the best candidates for microcredit.

Extremely poor people who do not have any stable income – such as the very destitute and the homeless – are not ideal microfinance clients, as they will only be pushed further into debt and poverty by loans that they cannot repay. What these people require are safety nets that can help them with basic needs and which are provided by specific development pro-grams.

The professionalisation of the microfinance market will reduce interest rates in the future.

We expect that the present growth and professionalisation of the microfinance market will further reduce interest rates in the future.

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MFIs must continue to work to improve efficiency levels (operating expense ratios), to increase scale and improve leverage (debt-to-equity ratios). This will bring down the cost of providing loans, and increase benefits transferred to the poor in terms of improving loan products, better access to loans, and lower borrowing costs.

Sources used and further references

Sources used for this paper are the FAQs provided by the CGAP-Forum (www.cgap.org). Readers will find detailed calculations and background information in a paper prepared by CGAP which can be downloaded at:

http://www.cgap.org/html/p_occasional_papers01.html

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