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DONOR BRIEF
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Helping to Improve Donor Effectiveness in Microfinance

MAKING SENSE OF MICROCREDIT INTEREST RATES

Why do microfinance institutions (MFIs) charge such high interest rates to the poor? This brief highlights some of the key issues related to microcredit interest rates and the role of donors.

Microcredit interest rates are set with the aim of providing viable, long-term financial services on a large scale. MFIs must set interest rates that cover all administrative costs, plus the cost of capital (including inflation), loan losses, and a provision for increasing equity. Unless MFIs do so, they may only operate for a limited time; reach a limited number of clients; and will tend to be driven by donor or government goals, not client needs. Only sustainable MFIs can provide permanent access to financial services to the hundreds of millions who need them.

Although microcredit interest rates can be legitimately high, inefficient operations can make them higher than necessary. As the microcredit market matures in a given country or region, donors and others should pay more attention to reducing operating costs to ensure the most efficient, competitive interest rates possible.

Why are microcredit interest rates higher than bank interest rates? Because the costs of making a small loan are higher in percentage terms than the costs of making a larger loan.

- If the actual cost per loan is $25, the percentage cost is 0.25 percent for a $10,000 loan, but 25 percent for a $100 loan.
- The percentage cost of making microloans is even higher because clients generally have no credit history, no collateral, are frequently illiterate, and often live in remote areas. It is expensive to go to these clients' doorsteps and intensively monitor repayments.

How can poor people afford such high interest rates? Clients favorably compare microcredit interest costs to their overall business or household costs, their income streams, and informal financial alternatives. The poor consider access to credit more important than the actual interest cost.

- For a microentrepreneur, the cost of a microcredit loan represents a small proportion of total business costs. A three-month $100 microloan with a 6 percent monthly interest rate, calculated on a declining balance, costs a client a total of $12.23. A study in Chile, Colombia, and the Dominican Republic found that a 6 percent monthly interest rate represented less than 3.4 percent of a typical microentrepreneur's total costs.
- A poor entrepreneur, especially one engaged in trading, can generate greater benefits from additional units of capital than can a highly capitalized business, because she or he begins with so little. Studies covering India, Kenya, and the Philippines found that the average annual return on investments by microbusinesses ranged from 117 to 847 percent.
- Interest rates charged by moneylenders are overwhelmingly higher than those of MFIs. It is common for moneylenders to charge effective interest rates in excess of 10 percent per month. A standard moneylender loan in the Philippines is the "5/6 loan" – for every five pesos borrowed in the morning, six must be repaid by evening. This amounts to a *daily* interest rate of 20 percent.

Should donors ever subsidize interest rates in microcredit? Isn't it the role of donors or governments to cover some of the costs of credit for very poor people? Subsidized interest rates generally benefit only a small number of borrowers for a short period. Interest rate subsidies are an inappropriate use of donor or government funds because they distort markets and can encourage rent-seeking. Programs that target specific populations with subsidized interest rates have generally suffered low repayment rates, institutional dependency, and limited growth. Clients often view these loans as one-off "gifts" that need not be repaid.

- Subsidies are necessary during the start-up stage of an MFI, but they are best used to cover operating costs and to build MFI systems and staff capacity.
- It can take several years for an MFI to reach the scale and efficiency needed to cover its costs from interest income. Donors can play an important role during this period by using subsidies to build the capital base of efficient MFIs, enabling them to grow more quickly, increase their leverage, and serve larger numbers of clients on a sustainable basis.
- If a donor's objective is to transfer resources to poor beneficiaries, microcredit might not be the most effective tool. Other types of interventions such as support for social services and even grants might be more appropriate for extremely poor or destitute populations.

How can a donor tell if interest rates are unnecessarily high due to inefficiency? Compare efficiency ratios and interest rates with similar institutions and the informal sector.

- *The MicroBanking Bulletin* (MBB) is the leading public source of comparative financial ratios in microfinance. After standardizing data from 148 MFIs around the world, the MBB compares key indicators by region, methodology, scale of operation, target market, age of institution, etc. (See examples below.)

Administrative Expenses as Percentage of Loan Portfolio by Region	
Asia	18.9 %*
Eastern Europe	20.1 %
Latin America	23.3 %
Africa	38.2 %

*All figures for financially self-sufficient MFIs.

Portfolio Yield by Scale of Operation	
Large MFIs	31.6 %*
Medium MFIs	43.4 %
Small MFIs	48.2 %

- As MFIs mature and markets become more competitive, efficiency gains can allow them to reduce interest rates on microcredit loans. BancoSol in Bolivia approximately doubled its efficiency over the last ten years and lowered its nominal interest rate from 50 percent to around 24 percent.

MFI interest rates must legitimately cover operating costs, but those costs should be as efficient as possible. How can donors help?

- **Avoid setting interest rate caps.** Decisions on interest rates are best made by MFI managers. Interest rates that do not allow an MFI to recover its costs will ensure its ultimate failure.
- **Focus on increasing MFI efficiency.** High administrative costs are the reason many MFIs charge high interest rates. Donors can provide support to MFIs for technical services that reduce costs and increase productivity, such as analyzing individual product costs and streamlining processes.
- **Require transparency in financial reporting.** Transparency enables stakeholders to understand the revenues and costs of an MFI. It also improves performance by challenging MFIs to compare themselves with their peers and find ways to improve their efficiency.
- **Support industry infrastructure (e.g., credit bureaus, auditor training).** Industry infrastructure includes services that enable all institutions to perform more efficiently. Credit bureaus help reduce MFI costs associated with assessing client credit worthiness. Audit services appropriate to microfinance help produce transparent and comparable financial statements.
- **Support a diversity of institutions (e.g., NGOs, credit unions, banks).** Each type of MFI has a different cost structure and different services for clients; a range of institutions will not only enhance competition, but also ensure clients have choices.

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Where to go for more information. Books/Articles: *CGAP Disclosure Guidelines for Financial Reporting by Microfinance Institutions*, provisional version (Wash., D.C: CGAP, January 2001); Committee of Donor Agencies for Small and Medium Enterprise/Donors' Working Group on Financial Sector Development, *Micro and Small Enterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries* (Wash, D.C: World Bank, 1995); "Financial Intermediary Lending," World Bank Occasional Paper No. 8.30 (July 1998); Malcolm Harper, *Profit for the Poor: Cases in Microfinance* (London: Intermediate Technology Publications, 1998); *MicroBanking Bulletin*, No. 7 (November 2001); Richard Rosenberg, "Microcredit Interest Rates" (CGAP Occasional Paper No. 1, August 1996); Marguerite Robinson, *The Microfinance Revolution: Sustainable Finance for the Poor*, Vol. I (Wash., DC: World Bank, 2001).
Websites: www.microbanking-mbb.org, www.cgap.org/html/p_occasional_papers01.html.

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