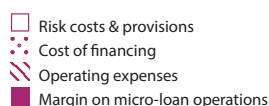


Why are interest rates in microfinance so high?

The question of why interest rates in microfinance are so high comes up often in discussions with investors. That is why this document provides a comprehensive analysis of interest rates in microfinance from the perspectives of two key stakeholders: (1) the microfinance institutions (MFIs) and (2) the micro-entrepreneurs.

MFIs' Perspective: Financial sustainability is important

MFIs are social businesses and strive to operate in a financially sustainable manner. This implies that interest rates on microloans must cover MFIs' costs of providing the loans, re-financing the portfolio and providing for bad loans. In addition the pricing should include a reasonable profit margin to finance future growth.



In LMDF's case the average interest rate charged by a partner MFI is 29.6%, broken down into operating expenses (20.1%), refinancing costs (7.5%), provisions on nonperforming loans (2.5%) and, on average, a small loss (-0.5%).

What stands out is that operating expenses are the largest determinant of the interest rate that borrowers end up paying, accounting for two thirds of the total rate. So why are operating expenses so high?

One important reason is that business models of MFIs are based on proximity to their clients who operate mostly in the informal economy. Clients are often visited on a weekly basis. Second, MFIs of limited size need to amortize necessary fixed costs such as IT systems, management or branches over a large number of very small transactions. These two challenges have not prevented MFIs from making significant progress in reducing their operating costs, often by reaching economies of scale or using technological advances such as mobile money or agency banking models.

The second cost item is refinancing costs—the interest that MFIs have to pay when raising funds in the form of savings from clients or funds lent from local banks and international investors.

The third cost item is loan loss expense, which, on average, represents 2.5% of the total interest rate. This percentage reflects the loans that the MFIs have to write off as irrecoverable.

Two important considerations need to be made when explaining interest rates for end-clients through the cost structure of MFIs: (1) what is a reasonable profit margin for an MFI, or when does it exploit its clients for its own interests? (2) does an MFI operate as efficiently as it should if costs are borne by the end clients through the interest rate charged?

We are confident that the answer to these questions, in the case of LMDF, is that MFIs do not generate excessive profits on the back of the poor and that operational efficiency is on average very good.



Micro-entrepreneurs' Perspective: The case for diversity,

reducing vulnerability and reliability

Pricing in microfinance is complex and it is insufficient to look at the supply side only. This second perspective looks at what we know about the demand side, i.e. how micro-entrepreneurs use microfinance, why they accept to pay—what appears to us to as—high interest rates and what alternatives are available to them.

Answers can be found in three fundamental needs that drive the financial activities of the poor: First, poor people with limited access to formal financial providers crucially need a diversity of financial services and providers. Diverse services, formal (MFIs, banks, etc.) and informal (family, friends, colleagues, money lenders, etc.), help match irregular, unpredictable and low incomes with daily needs (food, shelter, education, health, etc.).

The continued existence of money-lenders, even in environments where there is ample access to microfinance, illustrates the importance of a diversity of providers. Money lenders are probably much more expensive than microfinance in terms of interest charged but they are accessible and do not require lengthy forms and loan documentation to be filled out. They are also likely to be located just around the corner—and hence complement the offering of an MFI, which may be located further away and may only be accessible through periodic visits from loan officers.

Second, poor households are most vulnerable if faced with emergencies. If the household wants to avoid making enormous sacrifices such the fire-sale of assets, poor people need flexible financial products to cope with their exposure to risks. Here, savings and insurance services are particularly important.

Third, poor people need reliable financial services. Within the countless uncertainties and exclusions which characterize poverty, access to reliable and fair financial services is very important and matters much more than the price.

Beyond these three fundamental needs, we should not forget the nature of the informal economy in which micro-entrepreneurs operate. The fact that even after paying back a microloan with a relatively “high” interest rate poor people are still able to make some money should imply that the rate of return on the cash they invested in their businesses is remarkably high. One often overlooked fact is that for most of these activities, the principal input is the time and skills of the micro-entrepreneur him/herself.