FIELD Funder Guide






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Is the Price Right? The Role of Pricing in Microenterprise Lending

The past several years have seen a great deal of controversy regarding the interest rates and prices charged by some microfinance institutions (MFIs) in developing countries.[1] The debate has emerged in part because of the entrance and success of for-profit microfinance institutions that have, in some cases, reaped significant returns for their investors. Further, the ongoing discussion about interest rates and pricing is linked to an emerging concern about the extent to which MFIs are providing a route out of poverty.

The interest rates and prices charged by U.S. microenterprise lenders have, to date, not been significant issues of debate or discussion among practitioners, donors or in the general media. This is partly because interest rates in the U.S. are, for a variety of reasons, lower than those charged in developing countries. In fact, most, if not all, nonprofit microlenders in the U.S. are charging prices that are subsidized (in other words, are well below their costs). Most U.S. microlenders are, therefore, seen as "affordable" sources of financing that are a clear alternative to payday or predatory lenders.

Two emerging dynamics may lead to greater focus on interest rates and pricing in the United States. The first is the entry into some markets of several for-profit microlenders and microfinance institutions that have shown strong rates of growth over a short period of time but in some cases are charging substantially higher rates than nonprofit lenders.[2] The second is the growing recognition that the fact that the rates currently charged by nonprofit microlenders are well below their costs may be one factor hindering their growth and sustainability. This guide explores the issues relating to the pricing of microenterprise loans that funders may want to consider as they engage with lenders.

The pricing picture

There is no available industry-wide data on the prices charged by nonprofit microlenders.[3] However, FIELD has collected pricing information from a set of five lenders participating in its Scale Academy for Microenterprise Development. The interest rates charged by these lenders range between 5 and 18 percent (with most falling below 13 percent). Closing fees also vary, with some of the five lenders charging flat fees that range from $35 to $250 and others charging a percentage of the loan ranging from two percent to seven percent. Both interest rates and fees vary across the different loan products offered by these lenders, based on a variety of factors, including the source of the loan capital, and the size and purpose of the loan.[4]

In comparison, according to creditcards.com, the national average credit card interest rate was 14.67 percent as of April 27, 2011; the national average for business credit cards was 12.91 percent and for individuals with subprime

[1] Eva Pereira, "Re-Examining the Microfinance Mission: Should Interest Rates be Capped?" Forbes, September 30, 2010, http://blogs.forbes.com/evapereira/2010/09/30/re-examining-the-microfinance-mission-should-interest-rates-be-capped/, (accessed June 20, 2011).
Also, Aneel Karnani, "Microfinance Needs Regulation," *Stanford Social Innovation Review*, Winter 2011, http://www.ssireview.org/articles/entry/microfinance_needs_regulation/, (accessed June 20, 2011).

[2] Luz Gomez and Elaine L. Edgcomb, *A Newly Crowded Marketplace: How For-Profit Lenders are Serving Microentrepreneurs* (Washington, D.C.: The Aspen Institute, 2011), http://fieldus.org/Publications/ForProfitLenders.pdf.

[3] Although, there may be data available soon. The U.S. Microenterprise Census, conducted by FIELD at the Aspen Institute, includes a question on interest rates. Three hundred and sixty-nine microenterprise organizations provided detailed responses to survey questions in the last census, which collected data on 2008 performance. The current Census is collecting 2010 data, and the analysis is projected to be available in fall 2011.

[4] Elaine L. Edgcomb, Joyce A. Klein and Luz Gomez, *Dollars for Dreams: Scaling Microlending in the United States* (Washington, D.C.: The Aspen Institute, 2010), pp. 17-20.

credit the average was 23.95 percent.[5] In addition, rates offered by several for-profit microfinance organizations to microentrepreneurs in California and Florida vary broadly by market, ranging between 18 and 60 percent. Rates at the higher end are effective rates that include fees, while loans priced at the 18 percent level are also charged a five percent loan administration fee.

Transparency in Pricing

It can be difficult to compare prices for microenterprise loans given the range of factors that contribute to total costs. The recent controversy over the very high prices charged by some microfinance institutions – considered by some to be predatory – has led to efforts to promote greater transparency and fairness in pricing. One of these efforts, MFTransparency, works with international MFIs to provide tools and analyses that allow for consistent and clear calculations of loan costs. Their tools help institutions to calculate the Annual Percentage Rate (APR) and Effective Interest Rate (EIR) for their products.

In the United States, regulated lenders (including credit card companies) are required to present their costs by using the APR. Nonprofit microlenders are not subject to such rules; however, some are moving to endorse the SMART Campaign, an effort to provide greater consumer protection to microfinance clients worldwide through transparent pricing. For more information on these efforts, visit http://www.mftransparency.org/ and http://www.smartcampaign.org/.

What difference does price make?

Pricing schemes obviously have implications for both borrowers and lenders. From the borrower's perspective, the price of a loan includes the interest rate, any fees charged (fees can include origination or administration fees, servicing fees, and any fees associated with late payment), as well as any mandatory savings or collateral requirements.

While price is an important consideration when comparing different financing alternatives, it is not the only factor that contributes to the attractiveness or appropriateness of a loan and a lending organization. Speed and access are also critical factors, and, in fact, at least one nonprofit microlender has learned through market surveys that some potential customers are willing to pay significantly higher prices if they can access financing in days rather than weeks. This finding may explain, at least in part, the rapid growth of for-profit small dollar and microlenders that charge significantly higher prices than their nonprofit counterparts.

It is also the case that the impact of the interest rate on the total cost of obtaining financing depends on the size and term of the loan. As Table 1 illustrates, for smaller, short-term loans, even large variations in interest rates result in relatively little difference in terms of the monthly payment on a loan. On the other hand, for larger,

Table 1: Effect of Interest Rate on Monthly Loan Payments

	Loan Size and Term			
	$1,000/6 mos.	$2,500/1 yr.	$25,000/3 yr.	$25,000/5 yr.
Interest Rate	**Monthly Payment**			
50%	$191.80	$268.96	$1,352.85	$1,140.12
36%	$184.60	$251.16	$1,145.09	$903.00
17%	$175.03	$228.01	$891.32	$621.31
8%	$170.58	$217.47	$783.41	$506.91
Difference 50% vs. 8%	$21.22	$51.49	$569.44	$633.21

[5] Creditcards.com calculates a weekly average credit card rate based on rates for the 100 most popular credit cards in the U.S.; see http://www.creditcards.com/press-releases/CreditCards-Weekly-Credit-Card-Rate-Report-April-27-2011.php, (accessed April 27, 2011).

multiyear loans, higher interest rates can result in significantly higher monthly payments. This is important because one of the critical issues to consider in weighing the appropriateness and effectiveness of a loan is whether the debt service significantly constrains the business' ability to meet its obligations and to reinvest for growth.

From the lender's perspective, pricing is critical to sustainability (or profitability for for-profits). At present in the U.S., no nonprofit, community-based lenders are charging prices that allow them to fully cover the costs of their microlending operations (the full costs include the operating costs to make and manage loans, as well as the financing costs associated with any borrowed loan capital and the costs associated with loan losses). In 2010, the total cost recovery for the microlending operations of the five Scale Academy lenders studied by FIELD ranged between 12.2 percent and 36 percent. For 27 microlenders that reported data to FIELD's MicroTest program for 2009, the range was 0 to 46 percent. The mean was 23 percent and the median was 15 percent.[6]

Although from a sustainability perspective the prices charged by microlenders should be linked to their lending costs, in reality, there are a number of factors that influence the prices set by microlenders. Funding sources play a critical role, as both the price that microlenders pay for their capital and any restrictions or limits placed on pricing by donors and investors affect the prices that are charged. Public sector funders appear to be the mostly likely to specify the interest rates and fees that can be charged on loans made with the loan capital they provide. Staff and borrower perceptions about what is "fair" or "acceptable" also affect pricing. Interestingly, it seems that staff perceptions may be a more dominant factor here than borrower perceptions. Microlenders studied by FIELD have noted that their staff often resist higher pricing, and often need to be educated and even re-educated about the rationale for charging somewhat higher rates. They also note that staff believes that borrowers will be resistant to higher pricing, even when, in fact, most microlenders have done very little market research to test borrower perceptions.

Lenders' attitudes about the role of subsidy versus self-sufficiency also affect pricing decisions. Because no nonprofit microlenders in this country are achieving full cost recovery, all require some level of subsidy from private or public donors. However, conversations about loan pricing among the leaders of microlending organizations in the U.S. reveal differing attitudes about the extent to which organizations should be using subsidy, with some concerned that disadvantaged entrepreneurs borrowing from microlenders do not pay higher rates than those accessing more traditional financing sources, while others favor striving to eliminate the use of subsidy to the greatest extent possible.[7]

Funder Perspectives

FIELD interviewed several private funders to get their perspectives on pricing and interest rates. All expressed an understanding that microlenders do need to generate earned income to contribute to sustainability. They appreciate that lending costs can vary significantly depending on the market context — due to differences in cost of capital, borrower risk, and clients' willingness to pay, and based on their own assessment of available options, and their costs and benefits. Given these complexities, most do not have a predetermined perspective regarding what interest rates should be and speak more about wanting to enable microlenders to chart their own course in this area. The challenge for microlenders, as the discussion above illustrates, is that there seem to be very little market-specific data driving the pricing levels set out by microlenders.

Another issue involves language that is more difficult to consistently define. When discussing specific interest rate examples, funders use the language of "fairness" or "equity" as an added consideration for microlenders with respect to price. The difficulty in using this language is in the subjectivity of the terms. Is it fair and equitable to charge an interest rate that reflects the actual costs of serving an individual and sustains a mission-oriented organization? Or, is a fair rate no higher than those eligible for more mainstream financing sources would receive? Why should the disadvantaged pay more because of their disadvantage? Or, rather than a focus on a particular rate ceiling, should the emphasis be on whether the loans are achieving the right developmental impact? Until the emergence of the for-profit lenders discussed in this paper, these questions were not "top of the mind" considerations, as nonprofits appeared to be operating within a relatively narrow and modest band of rates. Now that these alternatives have appeared, the issue of fairness has taken on more urgency, but few funders have reached final conclusions that have converted into policies guiding decisionmaking.

[6] MicroTest data reported to FIELD for FY2009 and FY2010 performance.
[7] Edgcomb, Klein and Gomez, pp. 20-23.

Implications/issues for funders to consider:

As funders look to support microlenders, the preceding analysis suggests the following recommendations pertaining to pricing.

Gain a better understanding of how microlenders set their prices

As with any other financial institution, a microlender should have a clear pricing strategy, including a rationale for its rates. When looking at grantees or prospective grantees, funders should ask for and review this information to gain a better understanding of how microlenders have framed their decision and any local market differences that might be impacting price, such as costs, competition, borrower risk levels or other characteristics. Whether or not a funder has a policy on pricing, this knowledge can help inform grant-making and assure that funders are not surprised later about key policies of their grantees.

Examine expectations regarding scale and sustainability

In light of some of the tensions and potential market constraints surrounding pricing, funders should consider whether their expectations with respect to a program's scale and sustainability are reasonable and consistent. Funders could be faced with limited success if scale expectations are too high, while microlenders face limited means for cost recovery.

Support market research that could illuminate pricing sensitivity

As discussions with Scale Academy members brought to light, little market research on microenterprise client pricing sensitivity has been conducted to determine the "right" pricing scheme. Staff perceptions and leadership pressures can often strongly influence price points. In addition, contexts are fluid; the "right" price today could change down the road. To that end, market research should be replicated periodically to see whether future adjustments (up or down) to interest rates could or should be made.

Promote transparency rather than placing restrictions on pricing

As is true in the international context, the issue of uniform pricing caps devoid of local market knowledge can be problematic for the domestic nonprofit industry, especially with respect to sustainability. As illustrated in the table above, loan sizes and terms influence the actual cost that clients bear, and, capping costs across the board without consideration of different products, terms and clients could have a detrimental impact on overall program sustainability. Rather than promoting a particular price point, a focus on pricing transparency (see above discussion) could offer a standard language and approach to pricing in the industry, moving the discussion away from diverging opinions around 'fairness' and 'equity', and toward ensuring that clients can make their own judgments regarding what these terms mean for them, and how they evaluate price in relationship to access and speed. The promotion of principles such as the SMART Campaign can help lay the groundwork necessary to strengthen ethical business practices and consumer protections.

For more information

Dollars for Dreams: Scaling Microlending in the U.S. (May 2010) discusses the pricing, and considerations underlining it, of leading microlenders that participate in the Scale Academy for Microenterprise Development. Available from http://fieldus.org/Publications/DollarsForDreams.pdf.

A Newly Crowded Marketplace: How For-Profit Lenders are Serving Microentrepreneurs (March 2011) discusses the pricing of several for-profit lenders, comparing their rates to known nonprofit rates. Available from http://fieldus.org/Publications/ForProfitLenders.pdf.

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