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How Scale-Focused Microlenders are Pricing for Growth

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Table of Contents

Introduction

The small business credit gap has persisted since the Great Recession and is especially problematic for business owners seeking loans of less than $100,000. Many funders, investors, and policymakers who care about small business, and particularly about increasing access to credit for women and entrepreneurs of color, want microfinance institutions in the US to reach more customers.

However, achieving greater scale requires a willingness to confront the challenging economics of small-dollar business lending. Bankers will often note that it costs as much to originate a $50,000 business loan as a $2 million business loan. While that is somewhat of an overstatement, even microlenders with the most streamlined processes find that it costs around $1,500 to originate a $3,000 loan. At the industry-average interest rate of 7.5 percent[1], a $3,000 microbusiness loan would yield $123 in interest over a one-year term — meaning that the lender must raise more than $1,300 in grant funding or fees to cover the full cost of the loan.

As US microlenders have worked to develop business and revenue models that can support larger scale and impact, they have carefully considered the role of pricing. Most microfinance institutions (MFIs) working to aggressively expand their ability to deliver responsibly structured and underwritten loans have found that charging higher interest rates (averaging between 12 and 16 percent across their entire microloan portfolios) is essential to their ability to deliver more credit, particularly at the smallest loan sizes ($2,000 - $10,000). Their choice to charge higher rates on their small-dollar loans is based on weighing the impact of higher (but still affordable) costs to borrowers against the ability to use limited resources strategically to reach more customers. For example, while raising the interest rate on a 12-month, $3,000 loan from 7.5 percent to 16 percent

What are the outcomes from scaling microlending?

High-volume microlenders have demonstrated the capacity to deliver capital to entrepreneurs of color and women who generate revenues and create jobs in local communities. In 2014, surveys of borrowers from Opportunity Fund and the Accion US Network found that:

- 70% of loan recipients were entrepreneurs of color;
- 42% of borrowers were women; and
- At the time of the survey – about one year after receiving the loan:
  - 95% of borrowers were still in business;
  - Businesses had median revenues of $84,000 ($100,000 for full-time businesses); and
  - Businesses employed an average of 3.3 workers, including the owner.

[1] The prices charged by US microlenders are heavily influenced by their use of the Small Business Administration's Microloan Program. Loans made with funds borrowed from the SBA under the program are subject to limits on the interest rate and fees that can be charged to borrowers. In FY2016, the average interest rate on loans originated under the SBA Microloan program was 7.5 percent. See Robert J. Dilger, *Small Business Administration Microloan Program*, CRS Report No. R41057 (Washington, DC: Congressional Research Service, 2017), https://fas.org/sgp/crs/misc/R41057.pdf.

> While raising the interest rate on a 12-month, $3,000 loan from 7.5 percent to 16 percent increases the borrower's monthly loan payment by about $12, it more than doubles total interest paid on the loan from $123 to $266. With this additional cost recovery, the MFI can make more loans.

increases the borrower's monthly loan payment by about $12, it more than doubles total interest paid on the loan from $123 to $266. With this additional cost recovery, the MFI can make more loans with the limited grant funding it has at its disposal.

This paper explores the approach to setting prices that has been considered by MFIs focused on scale and growth. Choosing to raise prices often generates resistance from funders, stakeholders, and even an organization's own board members and staff. Interest rates that are higher than single digits are often viewed as violations of mission and core principles, even if they allow the MFI to dramatically increase the number of businesses they help start or grow, the number of jobs they create or preserve, and the impact they have on the communities about which they care. Yet many scale-oriented microlenders charge higher rates, often based on careful consideration of:

- The market environment in which microenterprises operate;
- The impact of higher rates on microfinance borrowers; and
- The impact of the higher rates on the MFIs themselves.

This paper examines the pricing of microfinance loans from these perspectives. Much of it is drawn from the experience of the Microfinance Impact Collaborative (MIC), a shared learning network comprised of six leading, high-volume MFIs convened and supported by FIELD at the Aspen Institute.

The Microfinance Impact Collaborative

The MIC is comprised of six microlenders that are among the industry leaders in originating small-dollar business and credit building loans:

- The Intersect Fund
- Justine PETERSEN
- Opportunity Fund
- Accion Chicago
- Accion East
- Accion Serving Arizona, Colorado, Nevada, New Mexico & Texas

In the one-year period between July 1, 2016 and June 30, 2017, the MIC members collectively originated 6,984 microloans with an average loan size of $9,451.

FIELD convenes the MIC members twice a year for multi-day meetings designed to provide opportunities for in-depth learning and exchange. These meetings set the stage for deeper collaboration among the members. To learn more, visit **aspeninstitute.org/programs/economic-opportunities-program/microfinance-impact-collaborative**.

The Market Context: The Availability and Pricing of Small Dollar Business Credit

The economics of small-dollar credit are challenging, especially for business lenders. The costs to acquire small business customers and underwrite small business credits are relatively high, and given the limited earnings on a small, short-term business loan, they are simply not profitable. Bank lending to small firms has declined significantly since its peak before the Great Recession. Federal banking data bear this out: data from the Federal Deposit Insurance Corporation show that small-dollar shares of lending to small businesses and farms declined from 33 percent in 2006 to 23 percent in 2015.[2] And a recent study by the Woodstock Institute found that the number of Community Reinvestment Act-reported loans under $100,000 nationally in 2015 remained 58 percent lower than in 2007.[3]

Yet the Federal Reserve's Small Business Credit Survey finds that most small business owners are seeking relatively small loans: 55 percent of small businesses surveyed were seeking less than $100,000, and 75 percent less than $250,000.[4]

Equipment and working capital term loans from a bank are favorably priced (5.5 percent - 6.0 percent in today's market), but they are usually not made in amounts under $10,000; are generally issued only to those with strong credit scores and histories and several years of well-documented financials; and must be fully backed by collateral. For small-denomination financing, banks usually push borrowers to business credit cards, which are priced much higher than term loans — between about 14 percent and 22 percent in today's market, depending on the borrower's credit history. Credit cards carry much higher interest rates than term loans in part because they are not secured by collateral; thus, the bank has no recourse if the card holder defaults. The relatively short term of the credit also leads to higher rates. Credit cards are also underwritten largely based on the business owner's personal credit score, so entrepreneurs with weak or thin credit typically cannot access them.

Most small business owners are seeking relatively small loans: 55 percent of small businesses surveyed were seeking less than $100,000, and 75 percent less than $250,000.

Small Business Credit Survey, 2016

[2] "Loans to Small Businesses and Farms, FDIC-Insured Institutions, 1995-2015," FDIC, accessed January 31, 2018, http://www2.fdic.gov/QBP/timeseries/SmallBusiness&FarmLoans.xls.

[3] Spencer Cowan, *Patterns of Disparity: Small Business Lending in Fresno and Minneapolis-St. Paul Regions*, (Chicago, IL: The Woodstock Institute, 2017), http://www.woodstockinst.org/sites/default/files/attachments/Patterns%20of%20Disparity%20Small%20Business%20Lending%20in%20Fresno%20and%20Minneapolis-%20St.%20Paul%20Regions.pdf.

[4] *Small Business Credit Survey 2016: Report on Employer Firms*, Federal Reserve Banks of Atlanta • Boston • Chicago • Cleveland • Dallas • Kansas City • Minneapolis • New York • Philadelphia • Richmond • St. Louis • San Francisco (New York, NY: The Federal Reserve Banks, 2017), https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf.

For small-denomination financing, banks usually push borrowers to business credit cards, which are priced much higher than term loans – between about 14 percent and 22 percent in today's market.

The post-Recession growth in the small business credit gap and advances in technology have led to the growth of alternative small business lenders, with many operating online. These lenders have lower costs than traditional banks due to lower levels of regulation, lower overhead costs, and the use of newer technology. They also offer a variety of products, from installment loans (both unsecured and secured), to merchant cash advances, to lines of credit and short-term daily-debit loans. These lenders use a variety of data points about the business and the business owner to inform their credit decisions. Their interest rates vary, with most charging rates well above those charged by microlenders. For example, average interest rates on the business loans originated by Lending Club have ranged from 7.17 percent on its highest quality ("A") loans to 24.16 percent to its lowest quality ("F and G") loans.[5] Annual interest rates on business loans from Funding Circle range from between 4.99 to 22.75 percent for 6-month loans to 8.26 to 26.99 percent for five-year loans.[6] OnDeck Capital's website notes that its rates begin at 9.99 annual interest rates for loans terms of one year or longer and that the weighted average annualized interest rate on term loans it originated in the quarter ending June 30, 2017 was 42.5 percent.[7] Opportunity Fund found that businesses that approached their organization seeking loans to take out high-cost financing had been charged an average annual percentage rate of 94 percent.[8]

In comparison, data from FIELD's US Microenterprise Census found that the mean average interest rate charged by microlenders in 2014 was 7.55 percent.[9] However, as we note, the rates charged by larger-volume microlenders are typically higher.

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[5] "Lending Club Statistics as of Sept. 30, 2017, Historical Returns by Grade," Lending Club, accessed December 28, 2017, https://www.lendingclub.com/info/demand-and-credit-profile.action.

[6] "Our business loan rates and fees," Funding Circle, accessed January 31, 2018, https://www.fundingcircle.com/us/rates_and_fees/.

[7] "OnDeck Term Loans," OnDeck Capital, accessed December 28, 2017, https://www.ondeck.com/term-loans.

[8] Research on financing received by small businesses that approached MIC member Opportunity Fund for refinancing found an average annual percentage rate of 94 percent across all the financing received, with one APR of 358 percent. See Eric Weaver, Gwendy Donaker Brown, and Caitlin McShane, *Unaffordable and Unsustainable: The New Business Lending on Main Street,* (San Jose, CA: Opportunity Fund, 2016), http://www.opportunityfund.org/assets/docs/Unaffordable%20and%20Unsustainable-The%20New%20Business%20Lending%20on%20Main%20Street_Opportunity%20Fund%20Research%20Report_May%202016.pdf.

[9] This finding is based on 83 microlenders that reported their average interest rate to FIELD.

The Borrower Perspective: Access and Affordability

Microentrepreneurs most frequently turn to an MFI because they have been denied, or believe they will not receive, a term loan from a bank. The clients who come to MIC members for a loan often have banking relationships, but these are typically limited to transactional accounts that they use for deposit and payments. Business credit cards are not an option for most of these entrepreneurs, either because they do not qualify for, or have reached the maximum limit on, a credit card. Instead, often their only realistic options, other than MFIs, are title loans or other forms of credit that can carry extremely high costs and may have other product features that can trap customers in a cycle of debt.

For these borrowers, the most important factors in seeking credit are access, speed, and affordability. Regarding access and speed, entrepreneurs want to know whether they will be approved for a loan, and they value a quick pre-approval. Applying for credit takes time, which is typically scarce for business owners. A borrower experience in which the business owner needs to gather many documents and wait perhaps weeks to know whether her loan will be approved creates uncertainty and uses valuable time. There is growing concern that MFIs routinely lose potential borrowers to faster online lenders even though MFIs offer more favorable pricing and loan terms. Thus, the high-volume MFIs have been investing in process and technology improvements to increase speed and customer responsiveness to remain competitive in the marketplace.

In addition to speed, business owners also focus on affordability. Affordability encompasses not just pricing, but other factors as well. Arguably, the primary challenge and responsibility facing a business owner is managing cash flow — the balance between dollars of revenue coming in versus dollars of expenses going out. Thus, often the first question a borrower asks when considering financing is "Can I afford the monthly payment?" In other words, most borrowers assess whether the return on the investment enabled by the loan (e.g., a new piece of equipment, purchase of additional inventory or raw materials, cash to manage seasonal fluctuations) justifies the additional monthly expense. When affordability is judged in terms of the effect of financing on cash flow, the term and the structure of the financing term can have a much more powerful impact than interest rate or pricing. This is not to say that interest rate does not or should not matter, but rather, that rate is only one of the factors that impacts affordability. And, in fact, modest increases in interest rates have surprisingly minimal impacts on monthly loan payments for smaller, short-term installment loans. Table 1 below shows the effect on the monthly payment amount of varying interest rates for smaller-dollar loans. The rates, loan amounts, and loan terms in the table are typical for nonprofit lenders that make microloans. As the table

Who are MFI Small-Dollar Customers?

- "Barely existing" businesses: informal, unincorporated, minimal to no formal financial statements or books, thin or no credit.
- Start-up businesses with less than 6 to 12 months of operating history.
- Steady but small businesses with relatively constant annual revenues between $12,000 and $150,000 that need financing to support resilience.

The term and the structure of the financing term can have a much more powerful impact than interest rate or pricing.

indicates, tripling the interest rate from 6 to 18 percent on a $1,500, 12-month loan increases the monthly payment by a nominal $8. As loan sizes and terms increase, the impact of higher interest rates becomes more pronounced. For a $15,000, 36-month loan, the same increase in interest rate from 6 to 18 percent yields an $86 increase in the monthly payment.

Table 1: Loan Payments at Varying Interest Rates

Loan Amount	Term (months)	Monthly P&I Payment at 6% Interest	Monthly P&I Payment at 12% Interest	Difference in monthly payment from 6% interest	Monthly P&I Payment at 18% Interest	Difference in monthly payment from 6% interest
$1,500	12	$129.10	$133.27	**+$4.17**	$137.52	**+$8.42**
$5,000	18	$291.16	$304.91	**+$13.75**	$319.03	**+$27.87**
$10,000	24	$443.21	$470.73	**+$27.52**	$499.24	**+$56.03**
$15,000	36	$456.33	$498.21	**+$41.88**	$542.29	**+$85.96**

The monthly payments presented in the table include principal and interest (P&I) only. They do not include any origination or closing fees, which are often rolled into the loan.

From an affordability or ability-to-repay perspective, the loan term has a more powerful influence on monthly loan payment than interest rate. In the table below, interest rate is held constant at 12 percent but the loan term is varied from 12 to 36 months. Extending the term from 12 to 36 months reduces the monthly loan payment by almost one-third. There are highly-warranted concerns regarding the predatory practices of many non-bank small business lenders. However, it is important to recognize that it is not solely the interest rates charged by these lenders that cause cash flow and solvency problems for small businesses; many of these lenders also lend relatively large amounts of money (tens or hundreds of thousands of dollars) over relatively short terms (between 6 and 18 months), so that monthly payments are quite high and therefore unaffordable.

In sum, while interest rates in the mid-to-high teens and low twenties may seem high to those accustomed to the rates charged on mortgages, auto loans, or credit cards for prime-quality borrowers, they can be an appropriate and affordable fit for small business customers if loans are appropriately structured and underwritten. From the perspective of borrower choice, MFIs fill an important gap in the market — reasonably priced small-dollar, short-term financing for borrowers with thin or weak credit histories.

Table 2: Monthly Payment by Loan Amount & Term Length

	12 Month	18 Month	24 Month	36 Month
$1,500, 12% Loan	$129.10	$87.35	$66.48	$45.63
$5,000, 12% Loan	$430.33	$291.16	$221.60	$152.11

The MFI Perspective: Balancing Cost Recovery and Efficient Use of Subsidy with Affordability for the Borrower

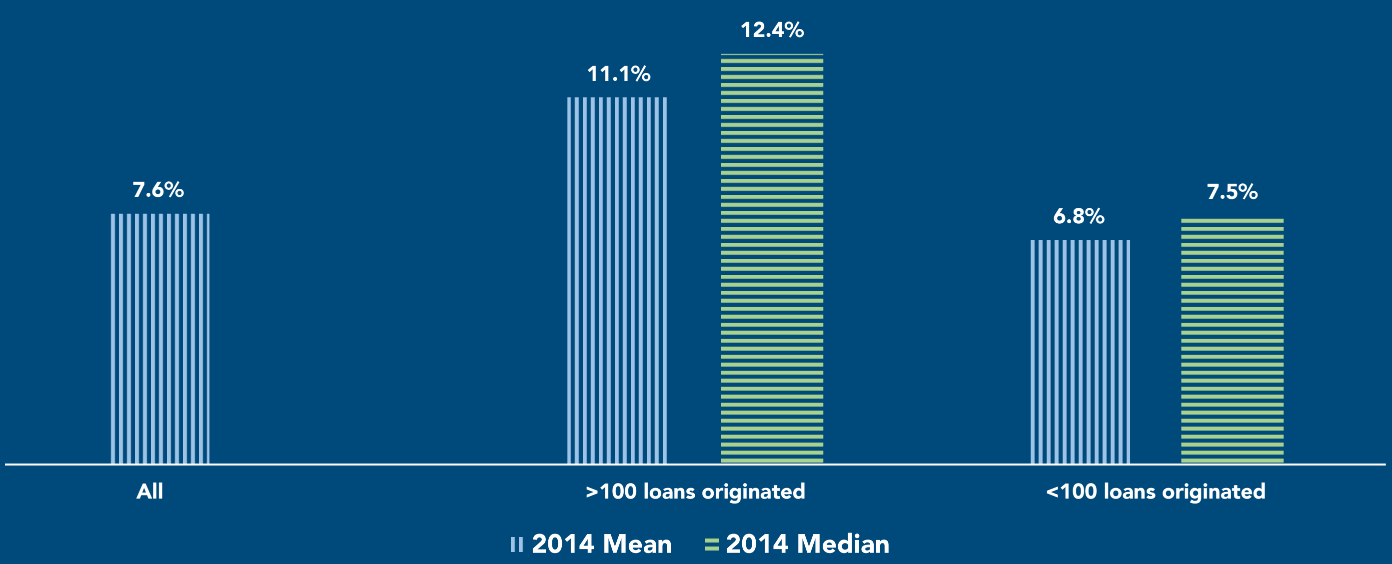
High volume MFIs such as the MIC members have defined their missions in terms of serving as many entrepreneurs as possible, which, in turn, leads them to make strong organizational commitments to grow. Scaling microlending is essentially a challenge of unit economics. If one is looking to scale a business where each transaction loses money, then the limiting factor is the amount of subsidy that can be raised to cover the operating costs associated with each additional loan.

Given the scarcity of subsidy for operating costs and the costs entailed in raising subsidy, most high-volume MFIs view pricing as an essential part of a multi-pronged strategy for achieving greater scale — a strategy that also involves reducing unit costs and raising operating subsidy. Combining somewhat higher pricing with increases in productivity and efficiency enables lenders to come closer to recovering their true costs of lending. These two steps drive down the amount of subsidy required per loan, making higher-scaled production possible.

Figure 1 below uses data from FIELD's US Microenterprise Census to illustrate the differences in pricing across lenders of different sizes. In 2014, the 16 organizations that reported making more than 100 loans charged a mean average interest rate of

Combining somewhat higher pricing with increases in productivity and efficiency enables lenders to come closer to recovering their true costs of lending. This drives down the amount of subsidy required per loan, making higher-scaled production possible.

Figure 1: Interest Rates Charged by Microlenders, by Number of Loans Originated



Source: Data is from the US Microenterprise Census, FY 2014. Calculations by FIELD.

A portfolio of 1,000 loans requires an additional $403,000 in subsidy, which could be used to originate almost 100 additional loans.

11.05 percent[10] and a median average rate of 12.36 percent. Among the 83 lenders that made fewer than 100 loans that year, rates were substantially lower: the mean average interest rate was 6.76 percent, and the median average rate was 7.5 percent.

For MIC members, pricing decisions are more complex than a simple choice to increase all interest rates by a few or several points. Most have adopted more granular pricing structures that reflect several factors, including the revenues generated from the loan, the cost to originate and service the loan, the risk of the loan (an expected loss rate), and affordability to the borrower. Affordability is also determined during the underwriting process when lenders compare debt service to revenues and total monthly obligations and set the loan size and term to match the borrower's ability to repay. Ideally, underwriters also structure loan payments to correspond to the revenues generated by the investment the loan supports.

The cost and revenue situation of one MIC member is illustrated in Table 4. It identifies the amount of subsidy necessary for loans of different sizes, terms, and interest rates, and illustrates the challenge of small-dollar lending. Even when the smaller, shorter-term loans are priced higher than larger, longer-term loans, the smaller loans still require proportionately more subsidy. Thus, a five-year, $100,000 loan priced at 9 percent will break even, but an 18-month, $5,000 loan at 15 percent interest recovers only $900 (or 45 percent) of the $2,000 cost to make that loan. To fully cover the origination cost, a $5,000 loan would have to carry a 40 percent interest rate, which the microlender is unwilling to charge.

The column "Subsidy at 8%" is analogous to the "Subsidy Required Per Loan" column, except that it assumes that each of the six loans carried an 8 percent interest rate (roughly the industry average noted above). Comparing those two columns, one can get a sense of how higher interest rates enhance cost recovery and reduce the required amount of subsidy. For a portfolio of 50 loans with an average size of $10,000, the choice to charge 8 percent versus 12 percent requires an additional $20,150 in subsidy (using the difference in subsidy per loan of $900). For a portfolio of 1,000 loans of the same average size, a rate of 8 percent requires an additional $403,000 in subsidy, which, at the costs below (of $4,100 to originate a $10,000 loan), could be used to originate almost 100 additional loans.

10 In the US Microenterprise Census, microlenders are asked to report their minimum, maximum, and average interest rate charged on their microloans. The data represent findings from the lenders that report both the number of loans originated and the average interest rate charged during 2015.

Table 4: Subsidy Requirements by Loan Size and Terms

Loan Amount	Term (months)	Rate	Revenue from Loan	Cost to Make Loan	Subsidy Required Per Loan (at interest rate in third column)	Subsidy Required Per Loan at 8% interest rate	Break-Even Interest Rate	Break-Even Annualized Percentage Rate
$2,500	12	18%	$400	$1,400	$1,000	$1,117	79%	88%
$5,000	18	15%	$900	$2,000	$1,100	$1,358	40%	46%
$10,000	24	12%	$1,800	$4,100	$2,300	$2,703	32%	36%
$25,000	36	11%	$5,600	$10,200	$4,600	$5,781	20%	23%
$50,000	48	10%	$13,300	$17,700	$4,400	$6,564	13%	15%
$100,000	60	9%	$29,500	$29,400	($100)	$2,670	11%	11%

MIC members also relate pricing to risk — which also relates to their costs as higher-risk borrowers can impose higher expenses in terms of both loan losses and collections. During the underwriting process, a borrower is placed in a risk tier based on factors such as credit score, credit history, availability of collateral, and business stage (start-up vs. existing). The risk tiers determine pricing such as interest rates and closing fees; in some cases, they also influence the maximum size of the loan. Table 5 provides a hypothetic example of risk-based pricing based on loan tiers. As is the common practice across the MIC members, the prices are highest for the shortest term, smallest loans to the riskiest customers.

Risk-based pricing offers several advantages to the MFI.[11] By setting stricter dollar amount and term length limits for high-risk borrowers, it controls charge-off losses from loans that fail. Placing higher rates and fees on high-risk loans enables more cost recovery on those loans that are likely to burden the organization the most (either through charge-offs or staff time to manage a problem credit).

[11] There are challenges to MFIs in building risk-based pricing models. Past performance is not necessarily a predictor of future results, and some — perhaps many — US MFIs lack sufficient amounts of historical data, or the capacity to clean, organize and analyze data necessary to develop a model that is statistically sound.

Table 5: Risk-Based Pricing System				
	Maximum Loan Amount	**Maximum Loan Term**	**Interest Rate**	**Fees**
Tier 1 (lowest risk)	$50,000	60 months	8%	3%
Tier 2	$35,000	48 months	10%	4%
Tier 3	$20,000	36 months	12%	5%
Tier 4	$12,000	30 months	15%	6%
Tier 5	$8,000	24 months	18%	7%
Tier 6 (highest risk)	$4,000	18 months	20%	8%

Conclusions

Scaling an organization's microlending beyond a few hundred (or even 100) loans per year is challenging when each loan requires thousands of dollars in subsidy. To achieve their stated missions of providing access to credit-starved communities, microlenders delivering large numbers of small-dollar microloans (those less than $15,000) are charging higher interest rates as part of a strategy to stretch limited subsidy across more borrowers. Although the rates they charge are higher than the industry average, their pricing is set with an eye toward ensuring that monthly payments remain affordable to borrowers.

Given the large gap in the supply of responsible small-dollar business credit and the challenges that microlenders face in financing the growth of their lending, it is essential to reconsider the role of pricing in scaling the growth of MFIs in the US. Private and public funders and investors in microfinance should reconsider funding strategies or requirements — such as interest rate caps or buy-down programs — that limit the ability of microlenders to most effectively use limited subsidy. Microlending organizations and staff with aspirations for growth should reconsider their pricing strategies with an eye to improving their cost recovery while maintaining affordability for their borrowers. As they do so, it will be essential to also assess their lending practices to ensure that their borrowers receive clear and timely disclosure of the rates, fees, and other costs associated with any financing offer and that their underwriting process assesses affordability and ability to repay. All advocates for greater access to business credit should realize that at the smallest loan sizes, there is a clear tradeoff between cost and expanded access that can and should be addressed thoughtfully and responsibly.

For more information

To learn more about microenterprise in the United States, visit as.pn/field.

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