The Case for Pricing Transparency

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Introduction

After decades of innovation and experimentation, microfinance sectors worldwide have achieved impressive successes. The microfinance community has joined efforts to achieve worldwide public recognition of microfinance as an effective and sustainable bottom-up approach to economic empowerment and consumption smoothing. The past years have seen equally strong efforts to provide a business case for microfinance, attract investors and access the global capital markets. As a result, the global microfinance industry has achieved a considerable record of transparency on financial performance. The true price of microcredit products, however, has never been accurately reported. As a double-bottom line industry that emerged to provide a low-cost alternative to the moneylenders, microfinance today is an industry where non-transparent pricing is common. Yet pricing transparency is critical in the market-based economy, as it promotes efficiency, healthy competition, innovation and affordable prices for millions of clients. For financial markets to develop sustainably and prosper, transparency is indispensable.

The financial crisis that has caused the collapse of the global financial system is a prime example for market failure and dramatically illustrates that non-transparency is a major market imperfection. The current crisis is the result of a lack of transparency, adverse incentive structures and inadequate competition. It underscores that bad practices can harm clients, responsible lenders, the entire financial system and the overall economy. While at the core of microfinance have been principles that could serve as an example for Wall Street, the rapid mainstreaming of microfinance makes the lessons learnt from the credit crunch ever more relevant. The collapse of the global financial system underscores the far-reaching risks associated with non-transparency and offers an opportunity to reflect upon the principles of responsible finance and build a solid foundation for the sustainable and healthy development of microfinance sectors worldwide.

The controversial debate on interest rates in microfinance has attracted the attention of the global community, governments, donors and investors in recent years, while the public media has often misreported on the interest rates charged in microfinance, without providing an explanation of why interest rates vary significantly among MFIs. In some markets, this has led to a political backlash resulting in counterproductive government intervention with lasting ramifications for the development of local microfinance sectors. This is particularly disturbing where governments react on negative public sentiment and intervene without understanding the implications for sustainable market developments, which is reinforced by an opaque pricing environment making it impossible to draw a line between responsible and irresponsible lending.

This article highlights the importance of pricing transparency for the market-based economy, examines the consequences of non-transparent pricing based on an analysis of industry data and evaluates approaches to pricing transparency at the government and industry level. The author would like to gratefully acknowledge the support of MF*Transparency*.

Pricing in Microfinance

As the goal of MFIs is to provide financial services to micro-entrepreneurs and low-income households on a sustainable basis, the interest rates charged on microloan products have to cover operating expenses, the cost of capital, loan loss provisions and a provision for growth. While the financial cost and loan loss provision tend to be relatively flat or the same percentage irrespective of loan size, operating expenses expressed as a percentage of the average outstanding loan balance increase significantly as

the loan amount decreases. Given this reality, pricing differentiation according to loan size is essential in microfinance. Because there is not one interest rate for every microfinance loan due to varying loan amounts, pricing transparency has been difficult to achieve.

The correlation between operating expenses and loan size based on the most recent industry data from MIX Market for MFIs in Peru is displayed in **Figure 1**. It clearly shows that operating expenses vary significantly according to loan size. The precise operating cost curve differs across regions and countries due to the unique economic conditions of each country, but the shape of the curve is essentially the same for microfinance sectors worldwide. **Figure 2** shows portfolio yield relative to loan size and as would be expected, the shape of the yield curve closely follows that of the operating expense ratio. The majority of MFIs included in this analysis appears to be generating yields within the average range of the Peruvian market, as displayed by the curve. It is interesting to note that disclosure of effective interest rates is required for regulated MFIs in Peru.

A major reason for non-transparent pricing in microfinance has been the difficulty of making the public understand why MFIs charge a range of interest rates on seemingly similar microloan products. Inaccurate and inconsistent reporting of loan prices has been a significant factor undermining transparency in the microfinance industry. It is important to recognize that there is no single market interest rate for microloan products. MFIs often offer different types of loan products which – depending on factors such as product use, loan size and geographic locations – have to be priced differently.

Figure 1: Loan Size and Operating Expense Ratio

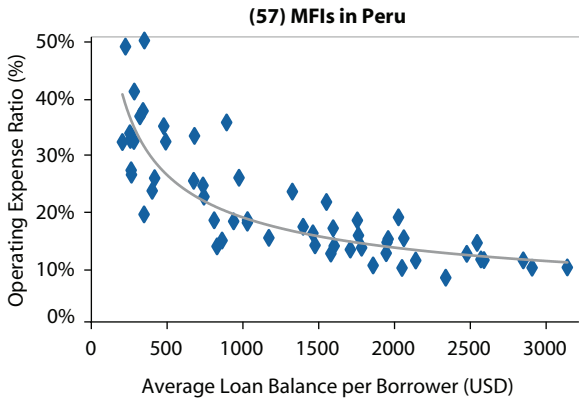
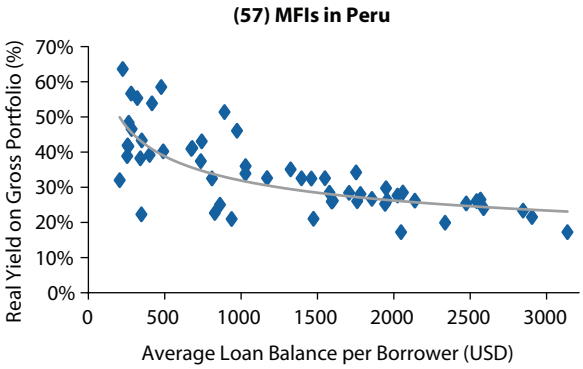


Figure 2: Loan Size and Real Portfolio Yield



The Consequences of Non-Transparent Pricing

The following analysis of industry data for the Mexican microfinance sector aims to examine the ramifications of non-transparent pricing.

Hypothesis 1:

When product pricing is non-transparent, institutions survive in the market despite inefficiencies, as they can pass on the higher costs to their clients.

Figure 3 shows the correlation of loan size and operating expenses based on the most recent MIX industry data for the Mexican sector. An analysis of efficiency for Mexican MFIs suggests that several MFIs are less efficient than the market average in a given loan-size category. As the size of the bubbles indicates, some of these inefficient institutions have a relatively large number of clients. They seem to attract clients and grow despite inefficiencies, while a number of efficient institutions are small in scale.

The high yields, as represented by the size of the bubbles in **Figure 4**, of those MFIs with an operating expense ratio above the country-specific average curve suggest that inefficient institutions may compensate for the higher costs associated with inefficiencies by raising prices and passing these costs on to the clients.

Hypothesis 2:

When pricing is non-transparent, some institutions can generate exceptionally high profits by charging prices above market rates.

Figure 3: Scale and Efficiency

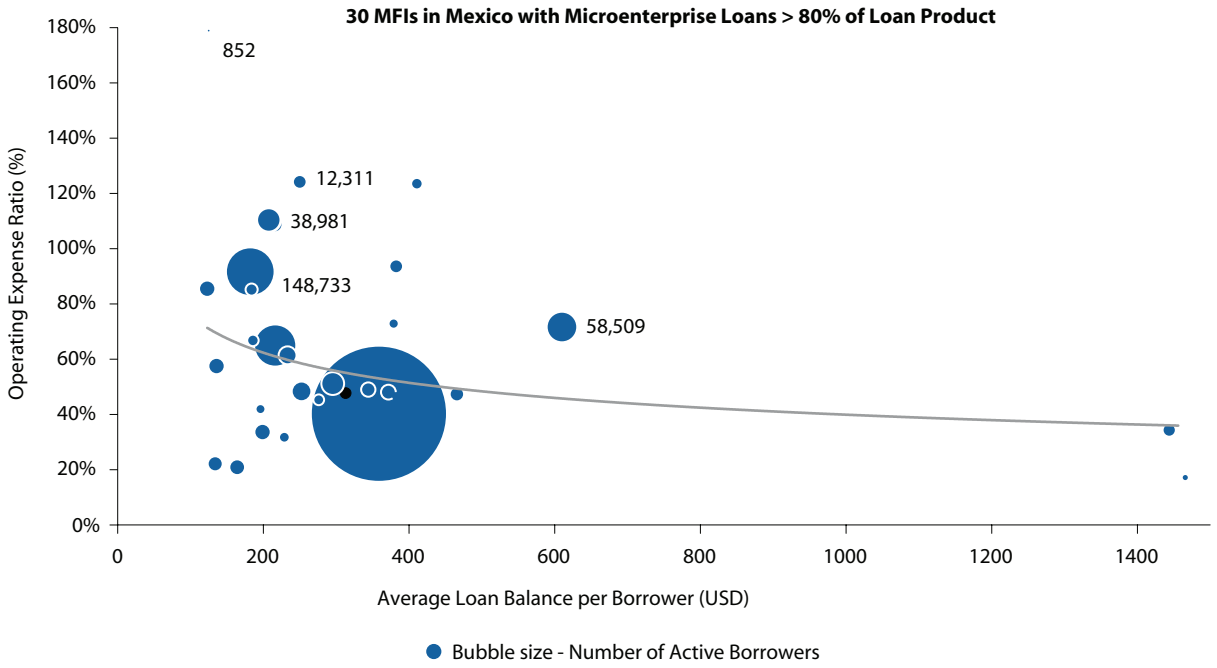
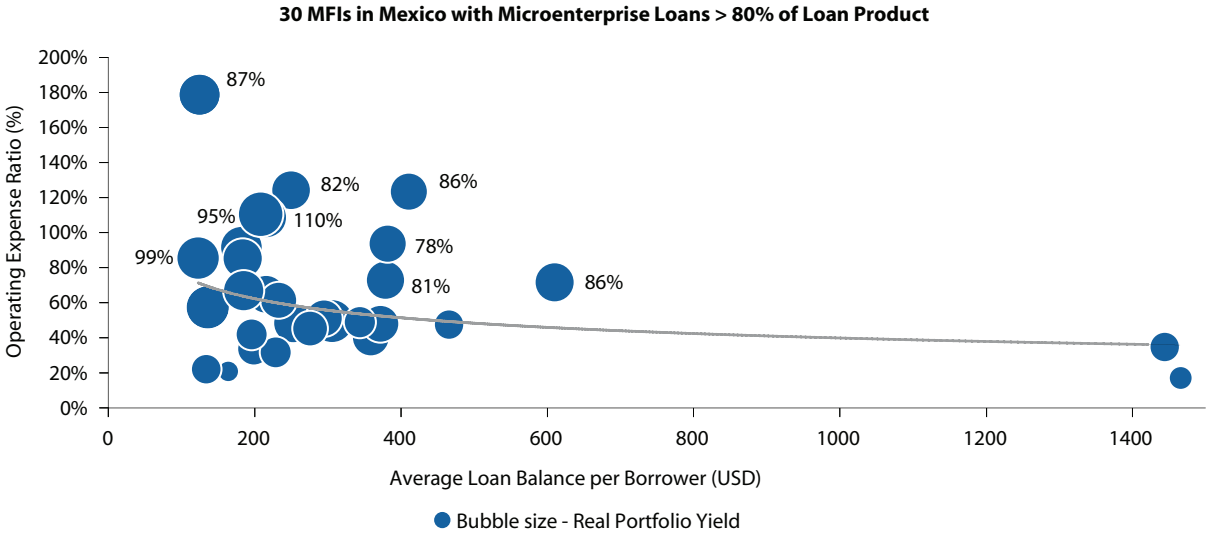


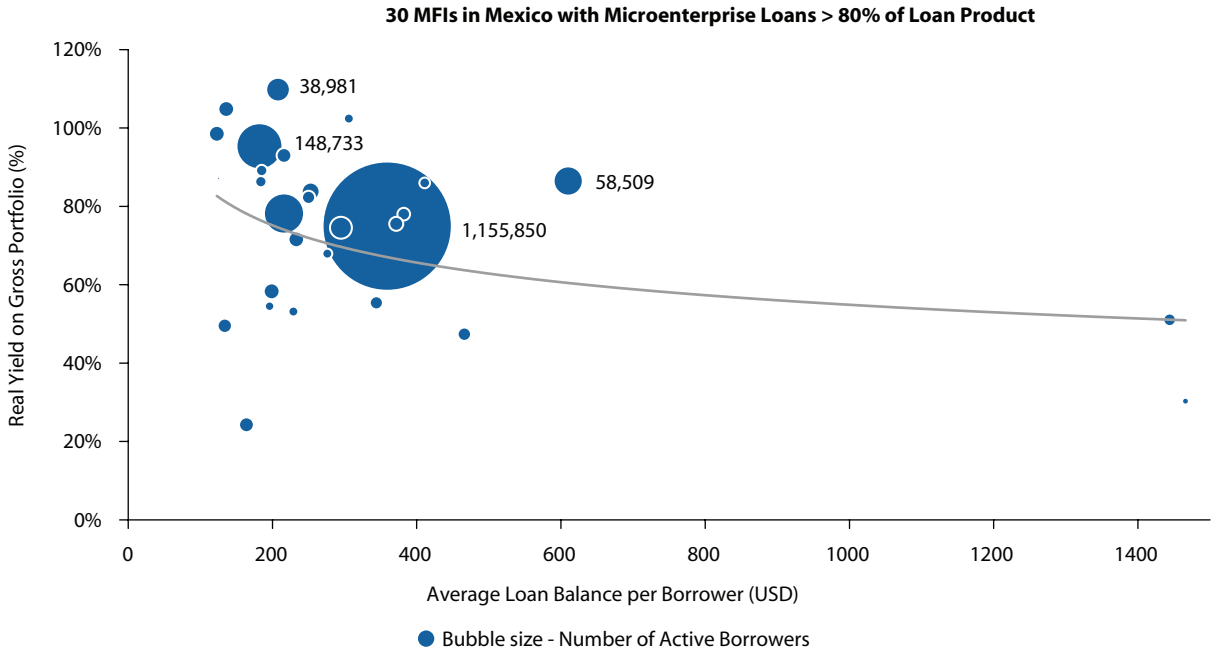
Figure 4: Loan Size, Operating Expense Ratio and Real Portfolio Yield



The correlation between loan size and portfolio yield for the Mexican market is displayed in **Figure 5**. The yields on gross portfolio of all MFIs reporting to the Microfinance Information Exchange, Inc. (MIX) are now available on MIX Market, which is an excellent advance. Portfolio yield offers a proxy for interest rates, although it does not consider differentiated pricing and only provides an average for the gross loan portfolio. For this reason, the present analysis only includes those MFIs whose microenterprise loans make up more than 80 percent of all products offered. As there is still little product differentiation in Mexico as compared to other microfinance sectors in Latin America and the Caribbean, the portfolio yield provided in **Figure 5** offers a reasonable proxy for interest rates charged.

Figure 5 reveals a wide range of yields on similarly-sized loan products. Several MFIs generate yields above the market average in a given loan-size

Figure 5: Loan Size, Portfolio Yield, Number of Active Borrowers



category. As the analysis shows, these high yields are generated by both institutions that are relatively small in scale and MFIs with a relatively large number of clients. These findings suggest that institutions are rewarded by the market and successfully attract clients even where their prices are above market rates. This analysis supports the findings of the 2008 MIX and ProDesarrollo Benchmarking report for Mexico, as it provides additional evidence for the hypothesis that intensifying competition does not put significant pressure on prices and profit margins, as new MFIs take advantage of the established growth and pricing strategies of larger MFIs.

As **Figure 6** shows, the high yields of some institutions are not necessarily due to higher operating expenses. Several MFIs have considerable spreads[1] as represented by the size of the bubbles[2], which suggest that they charge prices above market rates. This strategy allows them to make exceptionally high profits.

Hypothesis 3: Non-transparent pricing may result in adverse selection

As **Figures 3** and **5** suggest, the most inefficient MFIs in the analysis as well as those that appear to be generating exceptionally high profits by charging prices above market rates include several institutions serving a relatively large number of clients. Asymmetric information is a serious market imperfection, as it overrides the logics of the market. A lack of transparency undermines healthy consumer choice and the informed decision-making of a range of stakeholders, which can lead to adverse selection as the allocation of resources is distorted.

Stakeholders of the Mexican microfinance sector as well as other sectors worldwide expect the coming years will see consolidation of institutions. While this may generally be desirable in terms of efficiency, growth and value to the client, in non-transparent markets this consolidation process may result in adverse selection whereby the responsible and efficient players lose out and inefficient and high profit players survive. Pricing transparency is thus indispensable in the market-based economy.

Alternative Approaches to Transparency

Government Level

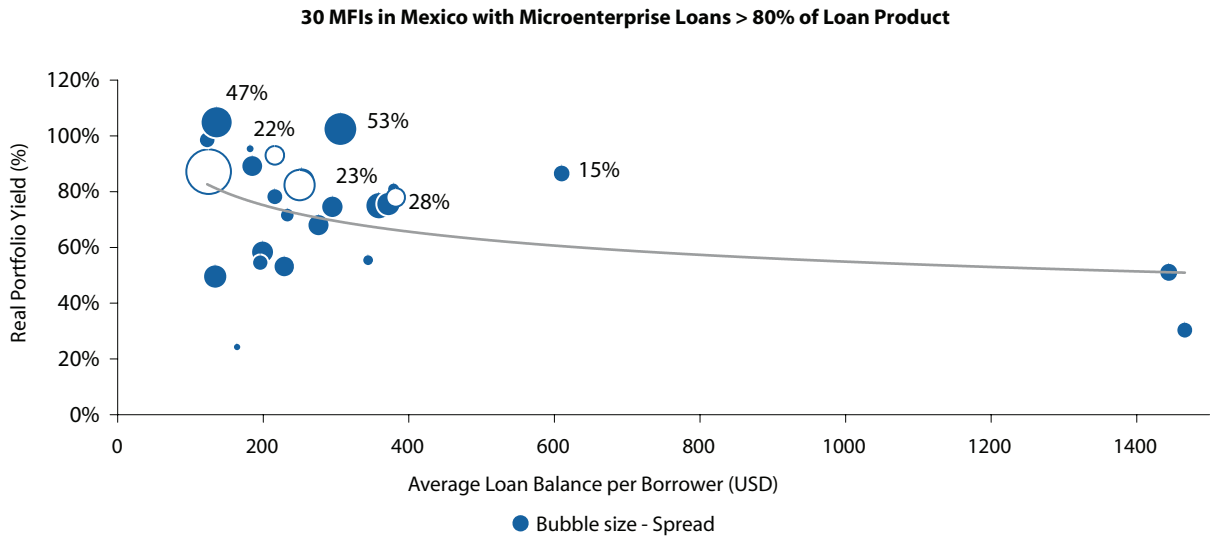
Truth-in-Lending Legislation

While interest rates can be legitimately high in light of financial sustainability, there are various techniques

[1] Defined as (Real Portfolio Yield – Operating Expense Ratio)

[2] Note: the white bubbles represent negative spreads

Figure 6: Loan Size, Yield and Spread



financial institutions can use to hide the true loan prices. As a response, governments in many countries have passed truth-in-lending legislation, requiring financial institutions to disclose the full costs to the borrower in a basic and consistent fashion, so as to allow for comparability among competing credit offers. The core approach of the Annual Percentage Rate (APR) and Effective Interest Rate (EIR) is to convert all the costs the client pays into an annualized declining balance interest rate[3]. In many countries where microfinance plays an important role, however, such legislation is either not in place or does not cover MFIs, as they operate under various and often special legal structures. In the medium-long term effective truth-in-lending legislation on a national level will be critical to ensure transparent pricing and healthy consumer choice.

The Impact of Interest Rate Ceilings

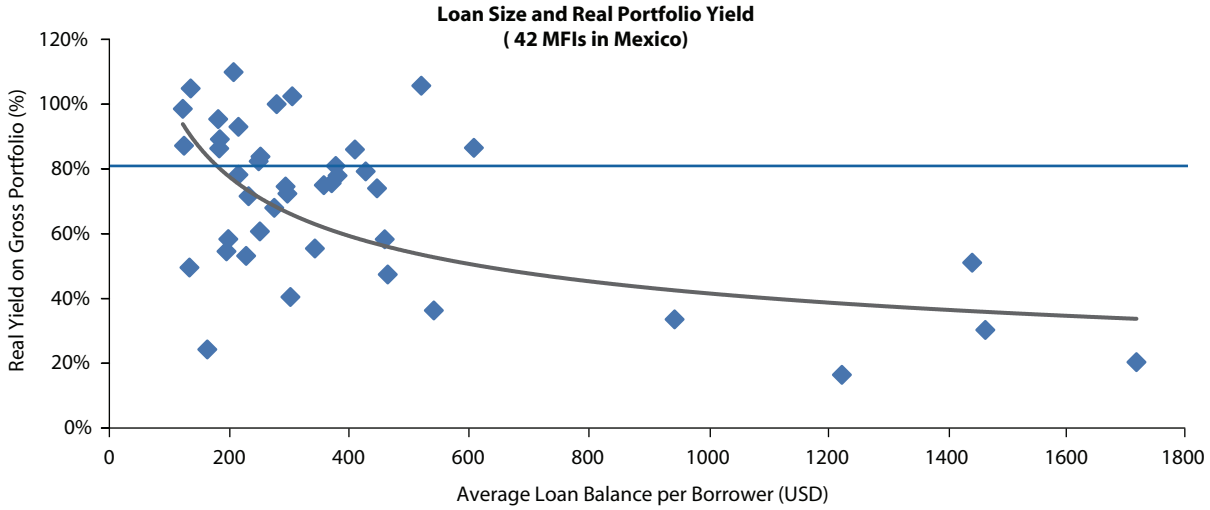
Interest rate ceilings have been proposed and discussed as a means of consumer protection in many countries in recent years. Despite good intentions, interest ceilings produce serious impediments to the development of a sustainable pro-poor financial sector.

When the government intervenes in the market, demand and supply cannot freely determine the equilibrium price and quantity. In the case where artificial ceilings are below the equilibrium price, the allocation of resources is distorted. As a consequence, people who demand small loans remain without access to finance, as the interest ceiling makes it uneconomical to serve them, and they are forced to turn to the informal economy. Interest ceilings ignore the fact that the main reason for high interest rates in microfinance is that it is uneconomical and therefore unsustainable to make small loans at lower interest rates. MFIs may leave the market, be hindered in their growth and market outreach, and adapt their products in a way that results in limited access, such as increasing the average loan size. Interest ceilings also lead to a concentration in geographic areas where costs are lowest. This policy may even exacerbate the lack of pricing transparency, as MFIs may be incentivized to hide the true costs to the borrower by adding hidden and confusing charges. As a result, this kind of government intervention will not only limit access to finance, but also undermine efforts to enhance transparency.

An analysis of the Mexican market including all MFIs reporting to the MIX shows that interest rate ceilings do not effectively prevent high profits made by unfair competition and have the adverse effect of limiting access to credit for the poor **(Figure 7)**. The interest rate ceiling would make small loans uneconomical and force MFIs providing these loans to increase the average loan size in order to be sustainable, even where the interest rates charged on these small loan products are legitimately high in light of institutional sustainability. At the same time, the ceiling does not prevent institutions from making exceptionally high profits, as high spreads can still be generated on larger loans.

[3] MF*Transparency* provides more detailed explanation, as well as software to calculate both the APR and EIR: www.mftransparency.org

Figure 7: The Impact of Interest Rate Ceilings



Competition determines the price of loan products, not legislation. Rather than regulating interest rates, governments should implement appropriate truth-in-lending legislation, stimulate competition, promote transparency and provide adequate consumer protection.

Industry Level

To ensure the integrity and credibility of the microfinance industry, industry-based truth-in-lending is indispensable while appropriate legislation is absent.

MFTransparency's Global Transparent Pricing Initiative

MF*Transparency* provides a venue for the microfinance industry to implement self-imposed global truth-in-lending standards and publicly demonstrate its commitment to pricing transparency, integrity and poverty alleviation. MF*Transparency* addresses pricing transparency through three joint initiatives. It facilitates transparent communication about loan products and pricing for all microfinance stakeholders by publishing the true prices for each microloan product in a given market in a transparent and consistent fashion. As an equally important initiative, MF*Transparency* develops and disseminates educational material to provide an advanced understanding of product pricing in the microfinance industry. MF*Transparency* also consults governments, regulators, donors, investors and other stakeholders on appropriate consumer protection and pricing transparency practices.

Market-driven Incentives

In an industry where non-transparent pricing has been practiced for decades, there is no incentive for any one MFI to take the first step in changing its behavior, even if the majority of MFIs would like to adopt pricing transparency. As a response to this first-mover problem, MF*Transparency* provides an opportunity for all MFIs to publish the details of their pricing all-at-once and country-by-country. As donors and investors choose to allocate their funds to those MFIs committed to transparency, there is a real incentive for MFIs worldwide to make their pricing practices transparent. Once transparent MFIs are rewarded by the industry's stakeholders, pricing transparency can become a real competitive advantage. At the same time, adverse behavior – such as introducing hidden costs, increasing the average loan size or focusing on areas cheaper to serve – will be prevented, as the public becomes more educated on how a variety of factors impact on loan prices in microfinance and why it is necessary to charge different prices for different microloan products.

Historic Data Launch

In October 2009, MF*Transparency* launched the world's first extensive and accurate publicly available pricing data for microfinance products in each market, beginning with Bosnia and Herzogovina, Cambodia and Peru. The pricing data for the pilot countries confirms that smaller loans have higher prices. The data analysis for these countries also clearly shows the broad range in quoted prices. Prior to the data launch, the microfinance community was unaware of

the market prices of the range of microloan products, as the actual APRs differ significantly from the quoted prices. Before product-specific pricing became publicly available with the MF*Transparency* data launch, the global industry relied on total portfolio yield as a proxy for interest rates. As portfolio yield provides an average of the different prices charged on all of the lender's products, it is not a useful indicator where MFIs offer a range of different products.

Conclusion

According to classic economic theory, the price of a good or service is determined by the basic law of demand and supply, where the lender's willingness to sell converges with the borrowers' willingness to pay. A situation of information asymmetry, however, where the buyer has no chance to access and understand the information necessary to make a sound decision, constitutes a serious market imperfection. Competition is generally beneficial for clients, but this is where a market price is determined by the dynamics of demand and supply. Markets in which non-transparent pricing is common, clearly lack this market price. An opaque pricing environment allows institutions to survive in the market despite inefficiencies or to generate exceptionally high profits.

A lack of pricing transparency may adversely affect the decision making of all industry stakeholders: clients cannot compare competing loan offers and make an informed decision. The price of a given product may not match the client's perception of the product's value, as she is not aware of the actual price she pays for the benefits of the respective product and the service with which it is provided. Given the lack of information as a result of non-transparent pricing that may disguise inefficiencies and exceptional profits, donors and investors are unable to allocate resources optimally. Policymakers may intervene in ways that harm responsible lenders, as they are unable to differentiate between responsible and less responsible market players. This may consequently lead to adverse selection: Responsible and efficient lenders are threatened to fall out of business, while inefficient and high-profit institutions may stay in the market.

The last decade has seen impressive achievements of transparency in the financial performance of MFIs worldwide. Microfinance is increasingly recognized as an asset class in the global capital markets, achieving both social and financial returns. Yet despite the industry's commitment to a strong social mission and double-bottom line aspirations, pricing transparency has not been widely practiced. Microfinance is a fast-expanding industry and as commercial approaches to microfinance continue to emerge, it is important that both parties gain. An opaque pricing environment, however, undermines equal transactions and consumer choice. Transparent pricing will harness the power of the market to facilitate an equitable exchange.