

## **Why Do MFIs Charge High Interest Rates?** (source: cgap)

Over the past two decades, institutions that make microloans to low-income borrowers in developing and transition economies have focused increasingly on making their operations financially sustainable by charging interest rates that are high enough to cover all their costs. They argue that this policy will best insure the permanence and expansion of the services they provide. Sustainable (i.e., profitable) microfinance providers can continue to serve their clients without needing ongoing infusions of subsidies, and can fund exponential growth of services for new clients by tapping commercial sources such as deposits from the public.

The problem is that the administrative costs are inevitably higher for tiny microlending than for normal bank lending. Lending out a million dollars in 100,000 loans of \$100 each will obviously require a lot more in staff salaries than making a single loan for the total amount. As a result, interest rates in sustainable microfinance institutions (MFIs) are substantially higher than the rates charged on normal bank loans.

There are three kinds of costs the MFI has to cover when it makes microloans. The first two, the cost of the money that it lends and the cost of loan defaults, are proportional to the amount lent. For instance, if the cost paid by the MFI for the money it lends is 10 percent, and it experiences defaults of 1 percent of the amount lent, then these two costs will total \$11 for a loan of \$100, and \$55 for a loan of \$500. An interest rate of 11 percent of the loan amount thus covers both these costs for either loan.

The third type of cost, transaction costs, is not proportional to the amount lent. The transaction cost of the \$500 loan is not much different from the transaction cost of the \$100 loan. Both loans require roughly the same amount of staff time for meeting with the borrower to appraise the loan, processing the loan disbursement and repayments, and follow-up monitoring. Suppose that the transaction cost is \$25 per loan and that the loans are for one year. To break even on the \$500 loan, the MFI would need to collect interest of  $\$50 + 5 + \$25 = \$80$ , which represents an annual interest rate of 16 percent. To break even on the \$100 loan, the MFI would need to collect interest of  $\$10 + 1 + \$25 = \$36$ , which is an interest rate of 36 percent.

MFIs have to charge rates that are higher than normal banking rates to cover their costs and keep the service available. But even these rates are far below what poor people routinely pay to village money-lenders and other informal sources, whose percentage interest rates routinely rise into the hundreds and even the thousands.

This does not mean that all high interest charges by MFIs are justifiable. Sometimes MFIs are not aggressive enough in containing transaction costs. The result is that they pass on unnecessarily high transaction costs to their borrowers. Sustainability should be pursued by cutting costs as much as possible, not just by raising interest rates to whatever the market will bear.

Interest rates, while still too high in some places, are dropping on average 2.3 percent a year. The microfinance industry has placed a lot of emphasis on improving efficiency in order to bring down these costs, so that poor clients are not paying unnecessarily high rates. New technology also offers to help reduce costs, so we expect rates to continue dropping as institutions become increasingly efficient at delivering services to poor people.

CGAP research found:

- MFI interest rates averaged about 28 percent in 2006, declining by 2.3 percent a year since 2003.
- MFI rates are lower than consumer and credit card rates in most countries, and usually far lower than rates charged by informal moneylenders.
- At an average 12.7 percent of portfolio in 2006, operating costs are the largest single contributor to interest rates, declining by one percentage point per year since 2003.
- MFIs on average have higher returns on assets than commercial banks, but produce lower returns on equity for their investors. At the same time, the most profitable 10 percent of MFIs were producing returns on equity above 34 percent in 2006. Some of these profits are captured in private pockets.