Transparent Pricing and the Microloan Price Curve

UNCITRAL
Vienna

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CEO
MicroFinance Transparency
January 2013
FREE
WI-FI
GREAT
BEER
GREAT SERVICE
ALL DAY
WAXYS.DE
1: What is a “transparent price”?  
2: Curves, not averages!  
3: The cost curve drives the price curve  
4: Profits come from being “off of the curve”
SECTION 1:

What is a “transparent price”?

What price DO we charge?

How should we DEFINE price?
### Which loan would you pick?

<table>
<thead>
<tr>
<th></th>
<th>Zero Interest Loan</th>
<th>Interest and Fees</th>
<th>And Savings</th>
<th>Interest Only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan amount:</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Loan term:</td>
<td>10 weeks</td>
<td>10 weeks</td>
<td>10 weeks</td>
<td>10 weeks</td>
</tr>
<tr>
<td>Interest Rate:</td>
<td>0%</td>
<td>15% “flat”</td>
<td>12% “flat”</td>
<td>40% decl</td>
</tr>
<tr>
<td>Upfront fee:</td>
<td>5%</td>
<td>2%</td>
<td>1%</td>
<td>0%</td>
</tr>
<tr>
<td>“Savings”:</td>
<td>0%</td>
<td>0%</td>
<td>20%</td>
<td>0%</td>
</tr>
<tr>
<td><strong>TCC</strong></td>
<td>$50</td>
<td>$50</td>
<td>$33</td>
<td>$42</td>
</tr>
<tr>
<td><strong>APR</strong></td>
<td>49%</td>
<td>47%</td>
<td>49%</td>
<td>40%</td>
</tr>
</tbody>
</table>

[mftransparency.org](http://mftransparency.org)
The Downward Spiral

1. How did prices get so confusing and non-transparent?
2. It is a combination of:
   1. Lack of transparent pricing regulation
   2. Initial motivation of a small minority to mask the true price
3. The result is a downward spiral drawing in nearly all MFIs
The Downward Spiral

1. All MFIs have transparent prices

1. MFI 1:
   1. Interest: 2.5% decl.

2. MFI 2:
   1. Interest: 3.0% decl.
The Downward Spiral

1. All MFIs have transparent prices
2. Some MFIs shift to flat interest

1. MFI 1:
   1. Interest: 2.5% decl.

2. MFI 2:
   1. Interest: 2.0% flat
The Downward Spiral

1. All MFIs have transparent prices
2. Some MFIs shift to flat interest
3. All MFIs shift to non-transparent pricing

1. MFI 1:
   1. Interest: 1.75% flat

2. MFI 2:
   1. Interest: 2.0% flat
The Downward Spiral

1. All MFIs have transparent prices
2. Some MFIs shift to flat interest
3. All MFIs shift to non-transparent pricing. And it continues

1. MFI 1:
   1. Interest: 1.75% flat
2. MFI 2:
   1. Interest: 1.6% flat, 2% upfront fee
The Downward Spiral

1. All MFIs have transparent prices
2. Some MFIs shift to flat interest
3. All MFIs shift to non-transparent pricing
4. Consumers struggle to choose.... Which would YOU choose?

1. MFI 1:
   1. Interest: 1.75% flat

2. MFI 2:
   1. Interest: 1.6% flat, 2% upfront fee
The Downward Spiral

1. All MFIs have transparent prices
2. Some MFIs shift to flat interest
3. All MFIs shift to non-transparent pricing
4. Consumers struggle to choose... Because the prices are far from clear

1. MFI 1:
   1. Interest: 1.75% flat
   2. APR: 37%

2. MFI 2:
   1. Interest: 1.6% flat, 2% upfront fee
   2. APR: 57%
The Downward Spiral

1. All MFIs have transparent prices
2. Some MFIs shift to flat interest
3. All MFIs shift to non-transparent pricing
4. Consumers struggle to choose
5. Profits are correlated to price when loans are identical

1. MFI 1:
   1. Interest: 1.75% flat
   2. APR: 37%
   3. ROE: 10%

2. MFI 2:
   1. Interest: 1.6% flat, 2% upfront fee
   2. APR: 57%
   3. ROE: 40%
The Downward Spiral

1. Prices are far from clear, and thus:
   1. Consumers over-consume
   2. Market competition is hindered
   3. Strong temptation from high profits
   4. The poor are harmed
   5. Public image is tarnished
   6. Governments urged to intervene

2. Transparency, and particularly pricing transparency, is a key element to correct this serious problem in the microfinance industry
The IPO in 2007 resulted in a 300-to-1 return on investment made in 2000.
ACCION’s Investment in Compartamos

ACCION (NGO) -> ACCION Gateway Fund (For-Profit) -> Compartamos (Sofol)
USAID -> $1M
$1M
Taxpayers -> $1M
$300M
### Mexico MFIs with > US$1M in profit in 2010

<table>
<thead>
<tr>
<th>Institution</th>
<th>Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>CompartamosBanco</td>
<td>$208M</td>
</tr>
<tr>
<td>Financiera Independencia</td>
<td>$45M</td>
</tr>
<tr>
<td>CAME</td>
<td>$6M</td>
</tr>
<tr>
<td>Apoyo Economico</td>
<td>$6M</td>
</tr>
<tr>
<td>FINCA - MEX</td>
<td>$6M</td>
</tr>
<tr>
<td>Invirtiendo</td>
<td>$4M</td>
</tr>
<tr>
<td>Conserva</td>
<td>$2M</td>
</tr>
<tr>
<td>Te Creemos</td>
<td>$2M</td>
</tr>
<tr>
<td>Mas Kapital</td>
<td>$2M</td>
</tr>
<tr>
<td>Solucion Asea</td>
<td>$2M</td>
</tr>
<tr>
<td>FinComun</td>
<td>$2M</td>
</tr>
<tr>
<td>SolFi</td>
<td>$1M</td>
</tr>
<tr>
<td>Forjadores de Negocios</td>
<td>$1M</td>
</tr>
</tbody>
</table>

**Total** $287M

*From MIX data*
“Should we use TCC with clients?”

(Total Cost of Credit)

• No!! TCC only works for exactly identical products
  • TCC is flawed even for products that seem very similar.
  • TCC is deceptive for comparing dissimilar products
• Why?
  • A client doesn’t *buy* a loan.
  • A client *rents* a variable amount of money for a variable amount of time.
  • We shouldn’t use a “purchase price”, we need to use a “rental price”
What is the APR?

(Annual Percentage Rate, using nominal annualization)

The APR indicates the cost for you to borrow $1.00 for one year. *It is a unit rental cost.*

An APR of 30% means it would cost you 30 cents to borrow $1.00 and keep the entire $1.00 for one full year.

The APR is an essential figure for you to compare the true cost of different loans.
“What costs should we include?”

- **Interest:** Certainly!
- What else? Everything that is a *compulsory requirement* for receiving the loan.
- **Fees:** Any compulsory fees must be included
  - **Training** fees? Yes, if the training is a requirement for the loan. The full-price is then for “credit-plus-training”
  - **Insurance** fees? Yes, if insurance is a requirement. The client can then compare: “Loan-only for 34% APR, loan-and-insurance for 38% APR”
  - **Security Deposits** (“Savings”): Yes! This is *not* savings!
SECTION 2:

Cardinal Rule in analyzing micro-loans:

Never use averages
Responsible Pricing Range

Too Low!

Too High!

Portfolio Yield by MFI
Philippines, 59 MFIs

Name of MFI

mftransparency.org
Portfolio Yield vs Average Loan Balance
Philippines, 32 MFIs

- Portfolio Yield vs Average Loan Balance
- Power (Portfolio Yield vs Average Loan Balance)
Portfolio Yield vs Average Loan Balance
Philippines, 59 MFIs

Average Loan Balance (US$)

Portfolio Yield (Nominal)
Why is there a price curve for micro-loans?
In the Philippines, we find a curve not only for prices, but also for Operating Costs.
Common industry benchmark of 15-20% OpCost Ratio is appropriate for larger loans.
But smaller loans generate an Op Cost Ratio well in excess of 20%
Portfolio Yield vs Average Loan Balance
Philippines, 59 MFIs

Portfolio Yield (Nominal)

Average Loan Balance (US$)

- Portfolio Yield vs Average Loan Balance
- Power (Portfolio Yield vs Average Loan Balance)
### Cost Components that Affect Pricing

<table>
<thead>
<tr>
<th>Component</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Costs</td>
<td>10%</td>
</tr>
<tr>
<td>Loan Loss</td>
<td>2%</td>
</tr>
<tr>
<td><strong>Operating Costs</strong></td>
<td><strong>20%</strong></td>
</tr>
<tr>
<td>Profit</td>
<td>3%</td>
</tr>
<tr>
<td><strong>Total Price</strong></td>
<td><strong>35%</strong></td>
</tr>
</tbody>
</table>
Realizing that there is a cost curve

<table>
<thead>
<tr>
<th>Efficiency</th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Cost per Loan</td>
<td>$50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan Size</td>
<td>$500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating Cost Ratio</td>
<td>10%</td>
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<tr>
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<td>$50</td>
<td>$50</td>
<td></td>
</tr>
<tr>
<td>Loan Size</td>
<td>$500</td>
<td>$250</td>
<td></td>
</tr>
<tr>
<td>Operating Cost Ratio</td>
<td>10%</td>
<td>20%</td>
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<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Cost per Loan</td>
<td>$50</td>
<td>$50</td>
<td>$30</td>
</tr>
<tr>
<td>Loan Size</td>
<td>$500</td>
<td>$250</td>
<td>$100</td>
</tr>
<tr>
<td>Operating Cost Ratio</td>
<td>10%</td>
<td>20%</td>
<td>30%</td>
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SECTION 4:

Prices and Profits

Profits are higher when prices are “off the curve”
What would happen if an Interest Rate Cap were passed?
These loan products would be subsized and shrink in supply....
While these loan products at above market rates, would remain.
Colombia has a 3-tier price cap
(showing values from 2011)
Transparency is essential

Price Caps without Transparency still leave a market overrun in confusion
Prices just aren’t hidden from others–
They aren’t really known to us!

Non-transparent prices introduce a serious market imperfection
that affects all stakeholders

• **Consumers** – They cannot make informed decisions
• **MFIs** – Most do not even know if their price is competitive, because they don’t know the true price of their competitors
• **Investors** – Making investment decisions without knowing the true price charged clients leaves potential of reputational risk
• **Regulators** – They cannot monitor the market and understand it without this information
Promoting Transparent Pricing in the Microfinance Industry

MicroFinance Transparency is an NGO registered in the USA