MicroLoan Foundation
a different approach to charity

Interest Rates

Interest rates for microfinance are nearly always higher than those charged by conventional financial institutions. Newcomers to microfinance tend to be surprised, and sometimes concerned, by this fact. This paper explains why this is the case.

Is it ethical to charge interest?

The microfinance sector is broadly united in believing that charging market-related interest rates is not only appropriate, it is essential in most circumstances. Organisations that offer loans at below market rates risk destabilising the sector in the country where they work with an unsustainable business model.

Most therefore believe that it is appropriate to set interest rates which cover administrative costs, the cost of capital, and write offs for an organisation. However, in the early years of a microfinance institution's life it may not be possible to set affordable interest rates that cover these costs fully. In such circumstances "smart subsidies", which cover an organisation's operational shortfall until it reaches sustainability, may be required. Two respected authors on microfinance, Armendáriz de Aghion and Morduch, endorse this approach in their book *The Economics of Microfinance*, observing that "there is wide acceptance of subsidies to help institutions get through initial start-up periods before scales of economies can be reaped." [1]

Why are microfinance rates higher than bank interest rates?

There are three key reasons that microfinance rates are higher than bank interest rates:

- **It costs more to administer a small loan**. If the costs of administering a smaller loan and a larger loan are similar in absolute terms, they will be greatly different in percentage terms. For example, if it costs £10 to administer a loan, this will equate to 0.2% of a £5,000 loan, but 20% of a £50 loan.

- **Inflation and bank rates in developing countries are often high**. Inflation and bank rates in developing countries are frequently in double digits – for example Malawi's inflation rate has averaged between *10% - 20%*[2] *over the past 3 years and its bank rate has been between 20- 30%*[3].

- **Microfinance clients are often more expensive to serve**. Microfinance often operates in remote areas, which are expensive to reach, or with uneducated clients who may require training and mentoring to be successful in their business activities.

- **The risk of lending is higher than in conventional lending**. While microfinance institutions are often rightly proud of their repayment rates (95% - 99% is common), the risk profile is likely to be higher than with conventional lending. For example, in the UK a typical consumer portfolio will have at any one time just 0.5% - 1% of its loan books in arrears. At the end of 2008, MicroLoan had a manageable 1% of its portfolio at risk (PAR),[4] and since inception its historic repayment rate is above 98%. However, during challenging periods (e.g. times of famine), PAR has been as high as 40%.

It is also worth bearing in mind that operating costs for microfinance are higher in Africa than any other region in the world. A report on the subject in the Microfinance Information Exchange states that: "Institutions suffer from the prohibitively expensive operating environments of African economies, in which weak infrastructure combined with predominantly rural markets and high labour costs all contribute to high expenses."[5]

To discuss any of the above in more detail or for more information, please contact us:

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What is an appropriate interest rate to charge?

The appropriate rate charged by an MFI is different in every country. It is important to consider the affordability of the loan to the client as well as the cost of servicing that client. While figures will vary considerably, as a broad guide sustainable annual interest rates tend to be lower (20-30%) in established microfinance markets such as Bangladesh or Mexico, and higher (30-80%) in less well-developed markets and rural areas such as sub-Saharan Africa. The typical rate for standard microfinance lending in Malawi is 5% per month – a nominal annual rate of 60%.

In a paper on interest rates, CGAP (a division of the World Bank) cite a study in Chile, Colombia and the Dominican Republic which is instructive for understanding how such rates can be affordable. It found that a typical 6% monthly interest rate (or a nominal annual rate of 72%) represented less than 3.4% of a typical micro-entrepreneur's costs[6]. This is because the returns on "micro" investments are much higher in percentage terms than those we are used to in developed economies. In the same paper, they cite a range of studies covering Kenya, India and the Philippines which found that the average annual return on investments by microbusiness ranged from 117% - 847%[7].

Moreover, the rates charged by moneylenders are typically far higher than microfinance rates. In her book *The Microfinance Revolution*, Marguerite Buckley studies informal lending rates in Asia and Latin America. Her findings show typical monthly rates of between 5%-1,000% (see fig.1).

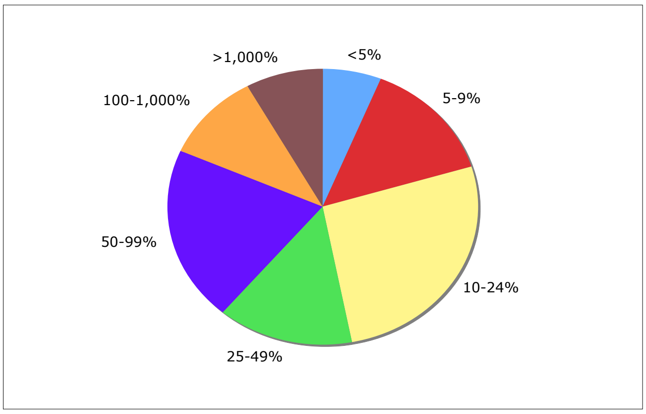

Fig 1: Monthly interest rates, informal money lending sector, Asia and Latin America

A separate study in Malawi[8] found that a common approach of informal money lenders in the country was to charge double the amount loaned, regardless of whether a loan was for a week, a month or a season. This translates roughly as nominal annual rates ranging from 170% - 5,000%. In this context, microfinance rates provide a vastly more affordable alternative.

Interest Rates and Sustainability at the MicroLoan Foundation

Our typical loan is at an interest rate of 20% over 4 months. We offer lower rates to longstanding clients taking out larger loans, with the best rate currently offered being an annualised rate of 43.2%. Our rates either match, or beat, market rates for microfinance in Malawi. Our average loan size, at £55, is among the lowest within the country, meaning that our cost of servicing loans is likely to be higher in percentage terms. We are regulated under Malawi law, and are registered with the NGO Board and the Malawi Microfinance Network (MMAN), who oversee matters including the appropriate levels for interest rates.

We never ask for security against a loan and we do not charge clients extra when repayments are delayed. However, clients who are more than 6 weeks late in repaying may not be eligible for further loans, depending on the reasons for the default in the first place.

The interest charged covers all associated costs, including training, mentoring and loan administration. We consider training to be a key component in our clients' ability to run a successful business, and all clients receive 8 training sessions before they are given their first loan. We do not charge clients for their loan passbooks, or to insure their loans against default, as is the case with some institutions.

We are committed to making our in-country operations sustainable in the long term through the interest we charge on loans. However, the rates we charge do not yet cover our operating costs and we do not wish to achieve this goal at the expense of universal access to our services. In Malawi – where we are most established – we aim to reach cash flow sustainability by the end of 2009. Our model is structured around providing microfinance economically and efficiently in rural sub-Saharan Africa, by keeping costs low and achieving scale in our operations. We use donations to fund start-up costs and operational shortfall until we reach sustainability.

Footnotes

1 *The Economics of Microfinance*, Armendáriz de Aghion and Morduch, p.245 (2005).

2 http://devdata.worldbank.org/external/CPProfile.asp?CCODE=MWI&PTYPE=CP

3 http://www.scotland.gov.uk/Publications/2005/06/09132146/21474

4 Portfolio At Risk (PAR) defined as payments over 14 days in arrears.

5 *Benchmarking African Microfinance 2005*, Microfinance Information Exchange (November 2006).

6 *Making Sense of Microcredit Interest Rates*, CGAP (September 2002).

7 *Ibid.*

8 *The Microfinance Revolution*, Marguerite Buckley (1996).

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