Pakistan Microfinance Network

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MicroNOTE

INTEREST RATE PANGS IN MICROFINANCE

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The world of microfinance has often faced the issue of high interest rates and its impact on low income clients.[1] Interestingly, this has mostly been a hot topic of debate either with policy makers or with the politicians; it is seldom an issue for clients. If you talk to clients, their biggest challenge is access to financial services, not the affordability of these services.[2]

Since pricing is a factor of risk adjusted costs, and relates to the market mechanism (i.e. benchmarking with competitor prices) discussion on both topics - costs of microfinance, and the rates that peer institutions are charging globally with specific reference to some Islamic countries - will be part of this paper. This paper will also review pricing from the perspective of a client, keeping in mind the importance of institutional robustness as an essential tool for the long term availability of financial services to the microfinance clients.[3]

The financial sector in Pakistan has shown remarkable growth and resilience in the last 10-12 years. This has been on the back of financial sector reforms that started in the mid 90s, and focused on privatization of state-owned banks, deregulation, and strengthening of the Central Bank. However, one of the challenges continues to be the shallowness of the financial sector, which still focuses its outreach in urban areas i.e. medium-high income groups, and the corporate sector. There has been very little focus on increasing access to the marginalized segments since these are considered risky and not cost-effective by the formal financial sector, and this holds true for all developing and under developed countries. Given the link between financial sector development and economic growth, governments and central banks have focused on universal access of financial services in recent years and microfinance has played a major role in achieving this objective.[4]

PMN thanks its members for contributing to this study. Our gratitude also extends to our donors for their continued support.

1. A recent World Bank research through its FPD Impact series issue 1 in February 2009 looks at control groups in Mexico and Sri Lanka and finds out average return on capital for micro enterprises at 68% in Sri Lanka and between 240% to 400% in Mexico. David McKenzie, **dmckenzie@worldbank.org** .

2. The Dynamics of MF expansion in Lahore, Hussan Bano and Mehr Shah

3. Microfinance clients hail from under-developed communities and belong to households whose members are economically active but remain un-served by the formal financial sector.

4. The World Bank Policy report “Finance for All? Policies and Pitfalls in Expanding Access 2008” provides an in-depth review of literature and findings on this relationship.

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Figure 1: Financial Access in developed and developing countries – Asia and the Pacific:

Countries:	Number of People/Bank Branch
Thailand	13,929
Philippines	12,773
Indonesia	11,845
Malaysia	10,208
Singapore	10,954

Countries:	Number of People/Bank Branch
Bangladesh	22,348
Pakistan	20,450
India	15,864
Sri Lanka	14,551

Source: World Bank and SBP Calculations presented by the Honorable Governor SBP at the financial inclusion conference in London, UK. 19th June 2007

With the above challenge in mind, the microfinance sector in Pakistan follows a strategy[5] that focuses on commercializing[6] microfinance with a mission to achieve social objectives[7].

In light of the challenge to expand access while maintaining certain ethos[8], it is important to discuss the reasons behind high costs of delivery, and higher lending rate for microfinance clients as compared to commercial bank clients. It is also important to compare interest rates in Pakistan's mf sector with some other countries and regions, and to look at the impact on the industry if institutions start charging subsidized or below cost lending rates. At the end we will share some policy measures that could help keep a check on the MFPs, so that their inefficiencies are not passed onto clients.

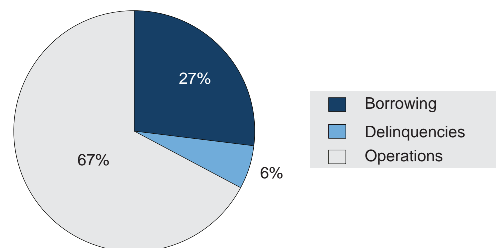
CORE ELEMENTS OF COSTS IN MICROFINANCE:

The cost structure of a typical MFP comprises following components:

1. Cost of Borrowing
2. Cost of Operations, and
3. Cost of Delinquencies

Compared with commercial / corporate banks where cost of borrowing is the main component, in the microfinance industry "cost of operations or intermediation costs" comprises around 70% of the total cost. Globally, the cost structure of a financially self sufficient MFP is graphically represented below.

Figure 2: The cost structure of a financially sustainable MFI:



Source: Micro Banking Bulleting, Issue Number 14 spring 2007. A product of MiX **www.mixmbb.org**

5. The Expanding Microfinance Outreach (EMO) Strategy was formally presented to the Prime Minister of Pakistan in February 2007 by the Governor State Bank of Pakistan. This strategy was subsequently approved in April 2007 and has now become a part of the GoP Poverty Reduction Strategy paper – II.

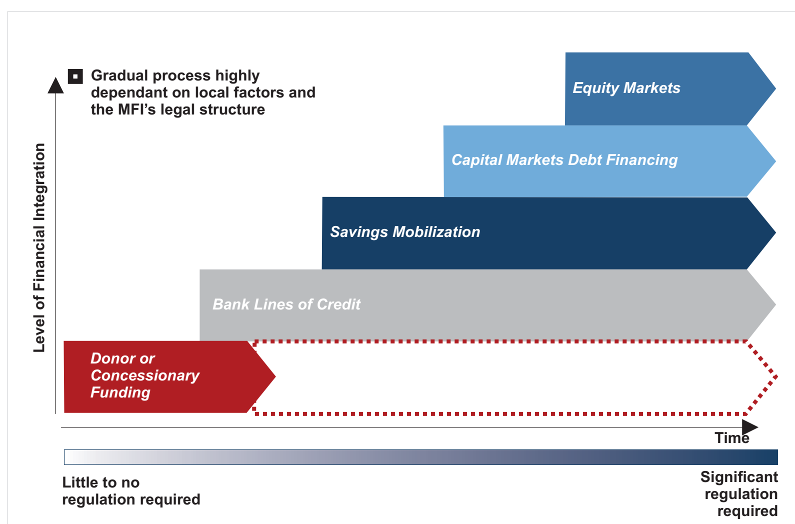
6. In our context commercialization means that microfinance is a formal financial industry that needs to be sustainable, rely on financial intermediation, achieves scale and should focus on tight controls to safeguard public deposits.

7. The objectives of the industry are to enhance financial penetration, increase financial access to the marginalized and un-served market segments, to increase their economic and social capital and to reduce vulnerabilities.

8. MF is a commercial activity that targets the economically active poor. It does not target the poorest who require other services like grant, food subsidy, skill development etc. In microfinance the business model used to increase financial access is commercial but the objectives are social.

If the funding structure of an MFI is plotted along its life cycle continuum, we will see a definite move from zero-cost donor funding to low-cost subsidized lending from apexes, to a move towards accessing commercial loans and finally public deposits and IPO issues on capital markets. This keeps the cost of borrowing for an MFP low when we compare it with any other financial institution, until it matures and starts depending upon purely commercial sources of lending and deposits. This is however different in the Pakistani context, where average cost of funds are higher as you will see in the next section.

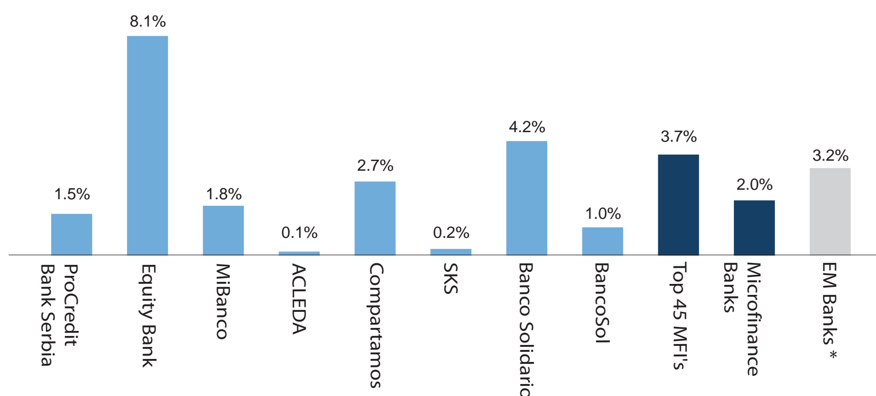
Figure 3: Stages of financial integration



Source: WWB occasional paper on financial products and services

The cost of credit risk is low for microfinance. This is despite the fact that microfinance organizations rely on cash flow based analysis or social/peer pressure, and provides unsecured lending to clients. Some of the reasons for low level of NPLs include: good knowledge of customers, frequent visits to clients businesses, nontraditional guarantees like group guarantees, excellent loan tracking systems that tracks arrears weekly or in some cases daily. This coupled with the fact that MFI clients' access depends on the repayment of previous loans and staff incentive systems are linked to not just booking a loan but ensuring that strong recovery rates translate into high asset quality.

Figure 4: NPL30, as of 2007: Solid Asset Quality



Source: CGAP occasional paper 14

Let us now discuss some of the reasons that explain high intermediation cost for a typical MFP:

1. These are unsecured small ticket loans, with an average loan balance of Rs. 11,500/- . In order to have a portfolio of approximately Rs. 20B, we need to lend to an estimated 1.8M clients. Typically a commercial bank[9] may need only 5-10 blue chips corporate clients to have such a huge lending portfolio.

2. The business model for both credit and deposit products in case of the MFP means that services are provided at the client's doorstep. The entire process of client acquisition, monitoring and retention entails a direct and continuous relationship between the client and the microfinance officer even post acquisition. This involves decentralized operations and decision making at the branch and loan officer level. For optimal staff productivity[10] we need 14k staff and 7.5k loan officers to serve 1.8M with a portfolio of Rs. 20B.

   Let us extrapolate and see the number of staff members that a mature and financially sustainable MFP will require at a gross outstanding portfolio of about Rs. 2.5 trillion as reported for commercial banks in a recent State Bank of Pakistan

Figure 5: Comparison of Human Resources Requirement – MF versus commercial banks

	MF Sector	Commercial Banks
Advances (Rs.)	21,427,205,282	2,524,700,000,000
Total Staff	9,529	148,292
Total Borrowers	1,871,508	4,781,509
Total Branches	1,594	7,630
Borrower/Staff	196	32
Advance/Staff (Rs.)	2,248,631	17,025,194
Advance/Branch (Rs.)	13,442,412	330,891,219

SBP Publications-Key Statistics of Scheduled Banks Dec 2007
Pakistan Microfinance Review 2007

	Commercial Banks	MFPs	Staff at Rs.2.5 trillion
GLP	2,524,700,000,000	21,427,205,282	2,524,700,000,000
Total Staff	148,292	14,621[11]	1,722,746.71[12]
Advance per staff	17,025,194	1,465,509[13]	1,465,509

The above tables clearly indicate that at a net advance of Rs. 2.5 trillion commercial banks can work with total staff strength of 150k individuals, whereas microfinance providers will require staff strength of upto 1.7M individuals. This clearly indicates the higher costs that the latter will incur to arrive at this figure for lending.

9. The only product that could be compared from commercial banks is their credit card segment, which is a small ticket item and is unsecured. The rate at which this product is charges to the clients is as high as 40% APR.

10. We have used staff productivity of a financially sustainable MFP as a benchmark for optimal staff productivity. See MBB 14, Spring addition. This is 128 borrowers per staff and 234 borrowers per loan officer.

11. Staff required at optimal level; 1,871,508/128=14,621

12. Total staff at optimal level for a MF portfolio of the size of a commercial bank:2,524,700,000,000/1,465,509=1,722,746

13. Advance per staff at optimal level: 21,427,205,282/14,621=PKR 1,465,509/-

3. This delivery model means decision making is done at the branch level and requires the establishment of a huge branch infrastructure. If you look at the above table you will see that the number of commercial bank branches are less than 7.5K for an advance portfolio of Rs. 2.5 trillion, indicating an advance-to-branch ratio of Rs. 330M. This in the case of MFPs in Pakistan is Rs. 13M. Extrapolating for Rs. 2.5 trillion of advances for the microfinance sector we will require 190k branches.

The above examples indicate the level of branch and HR infrastructure that the MFPs will require at the level of advances that commercial banks can operate on with les then 1/10th of the staff and branch network.

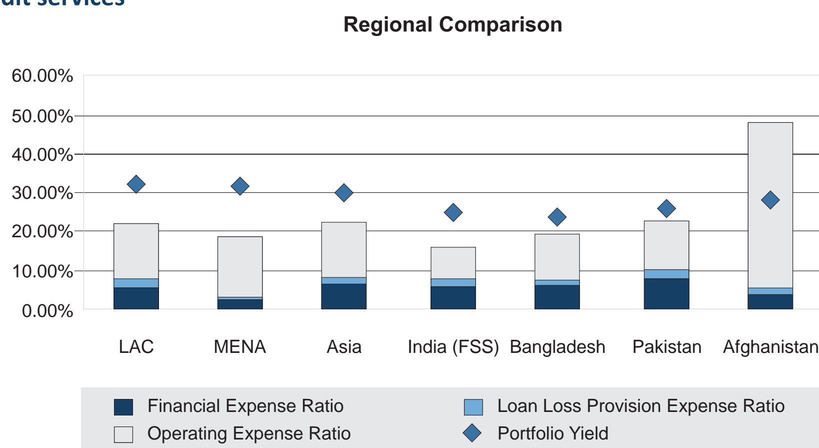
SO WHAT IS A SUSTAINABLE INTEREST RATE?

A lending rate that covers the cost of operations, cost of borrowing and cost of delinquencies is the break-even rate for a microfinance organization.

However, in order to provide sustainable services and to continue growing an MFP will require topping its break-even rate by adjusting its equity with the rate of inflation and add a margin to help in increasing the real value of its equity so that it can leverage deposits, commercial debt and onwards attract social/commercial investors to keep growing.

Let us look at the cost structures and portfolio yields[14] of MFPs in different regions[15] of the world and compare them to the average for Pakistan.

Figure 6: Regional and country level comparisons on costs and pricing of micro credit services



Sources: MBB issue 14, PMN PMR 2007 and 2007 Indian MF Review

The above table clearly indicates that portfolio yields across the globe are upward of 30%, except for South Asia. South Asia is skewed by two countries India and Bangladesh with a collective outreach of more than 20M clients, indicative of a mature market that has achieved economies in terms of cost structures. However, in both cases, portfolio yields are in line with Pakistan's' despite the lower cost structures.

Another important factor to note here is that lending rates in some of the Muslim countries are either upwards or almost in line with rates that are being charged in Pakistan (MENA-32%, Bangladesh-25% and Afghanistan-28%).

14. Portfolio yield is a proxy for effective interest rates charged by an MFP to its clients.

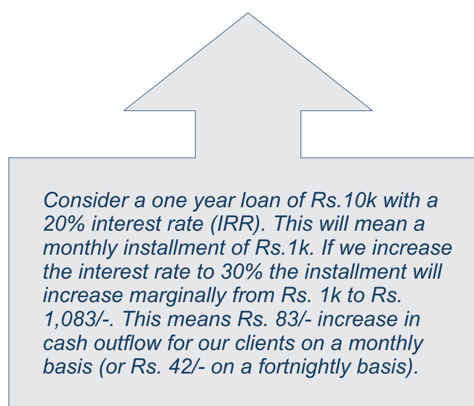
15. Micro Banking Bulletin

WHY IS IT IMPORTANT TO CHARGE SUSTAINABLE INTEREST RATES?

MFPs need to charge sustainable rate because:

a. By charging sustainable rates MFPs will have a strong balance sheet that could help in accessing finance from commercial sources, and hence lead to the increased growth and outreach of financial services for the poor.

b. An increase in effective interest rates by X% has a marginal impact on the monthly cash out flows of the clients; however it brings home huge earnings for the MFP, since we are talking about millions of clients. The following example, illustrates this point:



c. Let us look at the implications of such a marginal cash flow impact on the clients from the policy perspective:

   i. For 1.8M clients this means a revenue loss of Rs. 1.8B per annum and at 3M clients this will be Rs. 3B, as discussed above.

   ii. Assuming that this is the difference between a sustainable operation and an unsustainable sector, the difference will be borne by the public exchequer for covering losses incurred by a segment of the financial industry.

   iii. This injection from public exchequer has an opportunity cost that can go into smart subsidies for credit enhancement to the microfinance industry, or for safety net programs that can then be linked to microfinance providers. Similarly, these funds could be used for other development activities like health, education, farm to market infrastructure etc.

d. Generally when interest rates or service charges are reduced, this leads to the reduction of revenues for MFPs. Hence these institutions will focus on cost reductions, which lead to the closure of branches, scaling down of staff (ceteris paribus), and as a result hamper access to finance because branches are fewer in numbers and geographically dispersed.

   This is not to deny the fact that efficiencies cannot be achieved through i) improved staff productivity, ii) leveraging technology and iii) partnering with existing public and private infrastructure to gain efficiencies.

c. These factors (cost reduction techniques resulting in branch closures, reduces staff etc) lead to an increase in the overall cost of the client. Remember, cost of banking for a client includes – a) Cost of borrowing, b) transportation, and c) opportunity cost. We might lower the cost of borrowing but the cost of transportation and opportunity cost rises tremendously as clients have to pay more to travel and probably bear loss as their businesses are closed for the time that they go to visit a branch.

HOW COME MF CLIENTS CAN PAY SUCH HIGH RATES TO THE MFPS?

This is a question that comes to the mind of everyone; in fact some of us in the industry have had similar thoughts related to the costs and pricing of microfinance prior to understanding the nuances of the business. Here is how this happens -

1. The biggest concern for our clients is access to financial services, not the cost of those services.

2. It is pertinent to recognize that mf clients are already availing financial services, but from informal sources. These sources include: middlemen, feudal, shop keepers or the committee system. Terms and conditions of these informal credit suppliers are stringent both economically and socially. For example, the interest rates are between 100-200%, and the terms include repayment of principal in entirety otherwise partial will only be considered as payment of interest.[16] Similarly in labor terms borrowers are asked to pledge their children as bonded labor till the loan is repaid, another example is that the shopkeeper or supplier who has given you the credit requires you to both purchase the raw material and sell the good only to his outlet and that too when there is glut of the produce in the market, hence low price to the mf client.

3. The return to clients is high (it ranges between 150% for a grocery store in the rural areas of Pakistan to 100% for a service industry like barbers, shoe cleanser etc), since they have a low capital base, and focus on inventory or services turnover with high built in margins. A counter argument to this is that money is fungible and hence the capacity of the clients is limited if they have used their debt for some other purpose. However, the fact of the matter is that microfinance positions itself largely with the economically active low income segments of the economy, i.e. individuals / groups, involved in some productive activity. Other credit products are usually “bundled” with the productive loan; this acts as a filter/check on clients without an income generating source to service the repayments.

SO WHAT SHOULD POLICY MAKERS FOCUS ON?

For policy makers it is important to realize that the focus should be on efficiency and not just pricing. Also comparisons in terms of cost and pricing should be made with peers[17] and not with commercial banks, as discussed in length above. In case of the mf industry this includes MFPs and in certain cases the informal money lenders or the credit card segment of the commercial banking industry that is small ticket, high volume and needs no collateral.

The real question therefore, is not the interest rate that an institution is charging but:

1. How efficient an MFP is?

2. Is the MFP passing on its inefficiencies to the client?

3. Within the profit margin, is there an element of rent seeking or is this to benefit the clients by increasing outreach of financial services to the clients.

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16. A study of Informal Finance Markets in Pakistan, By Adnan Qadir 2005

17. The peers for microfinance include NGO MFIs and Licensed MFBs that are allowed to take deposits. It also includes MFI/MFBs within Pakistan, in the South Asia region and globally also. To make it apples with apples it is better to compare MFIs/MFBs keeping in mind their age, outreach, loan size and focus in urban vs. rural areas etc as they all affect cost of intermediations.

The following policy framework, most of the ingredients of which are already in place in Pakistan with SBP playing an enabling role with tight supervision, will help build a robust sector along with ensuring that the clients' rights are duly protected.

1. Promoting healthy competition by allowing in new players as identified in the MFI Ordinance 2001. This could lead to choices for the clients to bargain with MFPs both in terms of improved product quality and better pricing. A caveat however is to avoid multiple borrowing that can lead to over indebtedness and the creation of pyramid structures.
2. Tracking inefficiencies and rent seeking trends in the industry, which is we need to ensure that institutions are optimally utilizing their resources, improving productivities, reducing costs with increase in the value of loan book and checking that the profit margins are within reasonable limits. This can be done both through peer comparisons available on the mix market website or through country, regional and global level information available publicly.
3. Developing Consumer Code of Conduct with focus on setting up a monitoring and grievance readdressal system
4. Promoting transparency, and
5. Reviewing social and financial performance of the industry on a regular basis

MicroNOTE: Interest Rate Pangs in Microfinance

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