

Understanding Microfinance Interest Rates

Contextualizing the cost structure of microfinance institutions to assess
the reasonableness of rates charged

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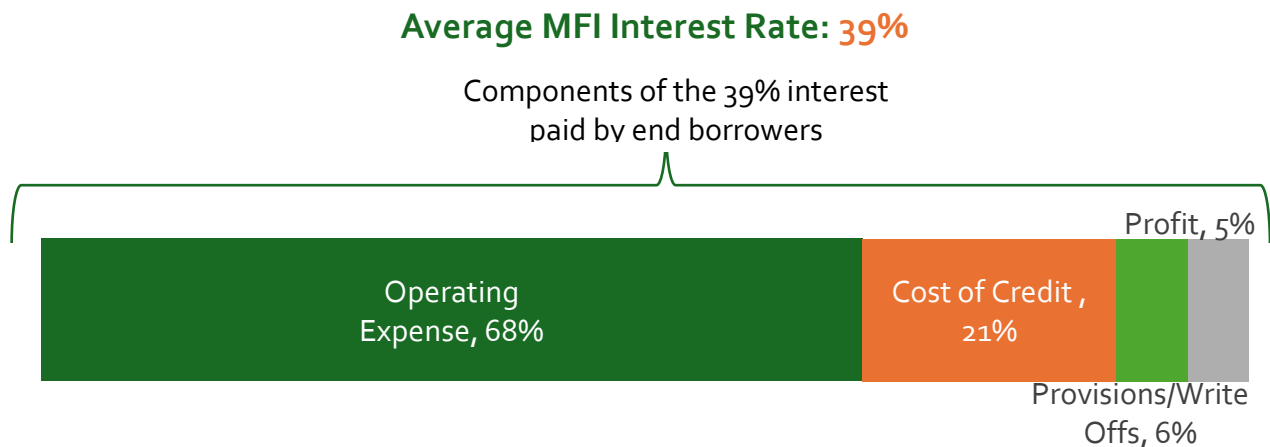
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Those considering investing in microfinance are often motivated as much by the social good that microfinance generates as by the financial return. Thus, it is common for microfinance investors to be concerned with the interest rates charged to end borrowers and the potential for predatory lending. With Invest Microfinance's 18-year track record in lending to microfinance institutions, we attempt to provide context for understanding microfinance interest rates and evaluating whether they are justified.

The annual interest rates charged to microfinance borrowers is often surprising to American audiences. Effective interest rates for end borrowers tend to be between 30-50% per annum. A survey of the twenty microfinance institutions (MFIs) in Invest's portfolio shows an average effective interest rate of 39% per annum. This is slightly above the 36% threshold that is often considered predatory in the United States, although it is below the typically triple digit interest rates paid by payday loan borrowers who have no credit history. To assess how reasonable microfinance interest rates are, it is instructive to examine the cost structure of these MFIs to understand what contributes to the interest rates being charged.

The following are average values calculated from Invest's MFI partners.



- **Effective interest rate as a percentage of Total Portfolio: 39.0%**
This represents the total cost the end borrower pays to the MFI. It is inclusive of interest and any fees associated with borrowing. When multiplied by the total portfolio, this value approximates the total revenue of an MFI.
- **Operating Expense as a percentage of Interest Revenue: 68%**
This value represents the percentage of an MFI's interest revenue that is used to pay for operations, with salaries and employee benefits making up close to half of this account. MFI salaries tend to be either at market, or slightly below market rate within the local economies in which the MFIs operate.

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- **Financial Expense as a percentage of Interest Revenue: 21%**
This value represents the percentage of an MFI's interest revenue that is used to service debt. This amount is inclusive of exchange rate loss on foreign currency loans.
- **Provision/Write Off Expense as a percentage of Interest Revenue: 6%**
This value represents the percentage of an MFI's interest revenue that it pays for its loan loss provision and write off expense annually. The modest value suggests that loan loss provisioning and write-offs are not a material driver of MFI interest rates.
- **Profit as a percentage of Interest Revenue: 5%**
This value represents the percentage of an MFI's interest revenue that is left over after paying its expenses. Some MFIs have ancillary revenue streams beyond interest/fee income to cushion profit, such as income from insurance sales or remittance services.

Consider the economics of a \$1,000 loan made by this MFI, which is representative of Invest's partners.

Total Revenue	\$390	\$1,000 X 39% (interest rate charged)
Operating Expense	\$265	68% X \$390
Financial Expense	\$82	21% X \$390
Provision / Write Off Expense	\$25	6% X \$390
Total Expense	\$372	\$265 + \$82 + \$25
Profit	\$18	Revenue (\$390) – Expense (\$372)
Net Margin	5%	\$18 / \$390

The above analysis suggests that operating costs, and in particular salaries and other personnel costs, are the main driver behind MFI interest rates. The next natural question to ask is, why are MFI operating costs so high? Consider the following:

- **Proportional cost:** The average loan size among Invest's partner MFIs is just under \$1,000. A \$1,000 loan takes the same amount of due diligence, processing, and monitoring, as a \$10,000 loan, but generates just one tenth of the revenue. MFIs which make smaller loans, reaching those at the lower end of the economic spectrum, need to charge a higher interest rate than banks which make larger loans.
- **Last mile borrowers:** A person who wants a loan from a bank would need to go to the bank (either online or in person). At an MFI, it is often the loan officers from the MFI who travel to meet the borrower. To serve rural borrowers, this can mean traveling for hours via motorbike

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on pot-hole-filled roads. The added cost of serving these 'last mile' borrowers is reflected in the operating expense.

- **Non-financial services:** Many MFIs have found that microfinance borrowers are most successful when they are supported in multiple ways. This has led many Envest partners to offer non-financial services such as financial literacy training, gender rights training, and training in craft and trade skills to their borrowers. These services cost money for the MFI to provide but are typically offered at no additional cost to the borrower.

In an attempt to protect the working poor, many well-meaning governments have imposed interest rate caps on what MFIs may charge at levels close to, or below prevailing market rates. There is an overwhelming body of evidence now that these binding interest rate caps have significant, unintended consequences that worsen financial opportunities for those they are meant to help. Consider how an MFI would respond to the three scenarios above in the context of an interest rate cap:

- **Proportional cost:** Since making small loans is proportionally more costly than making large loans, MFIs that are forced to maintain an interest rate ceiling often choose to abandon very small loans in favor of making larger loans. This effectively excludes those at the lowest end of the economic spectrum.
- **Last mile borrowers:** Serving remote borrowers is more costly than serving urban borrowers. If an MFI needs to reduce costs to maintain an interest rate ceiling, it will logically abandon rural borrowers in favor of those in urban centers.
- **Non-financial services:** Non-financial services cost money for the MFI to provide, but generate little to no revenue. When an interest rate cap is imposed, MFIs choose to abandon non-financial services to focus exclusively on revenue generating business.

Understanding the cost drivers for an MFI can help explain why MFIs charge interest rates that would be shocking in an American context. However, a key question remains:

Do end borrowers benefit from loans that cost 30-50% annually?

To answer this, let us consider the return on capital for most microentrepreneurs, as well as the repayment rate across the sector.

At the lower end of the economic spectrum, additional capital invested in microbusinesses offers a high rate of return. These returns tend to be much higher than the market rate for microfinance credit. A randomized experiment conducted in 2022 among microentrepreneurs in Pakistan showed that the average annual return on capital was between 103% - 143%.¹ A randomized experiment conducted in 2007 in Sri Lanka found the average return on capital to be approximately 68%.² An anecdote

¹ Maazullah Khan & Arjun S. Bedi (2022) Returns to Interest-free Microcredit: evidence from a Randomised Experiment in Pakistan, *Journal of Development Effectiveness*, 14:2, 93-107, DOI: 10.1080 /19439342.2021 .1964578

² Suresh de Mel, David McKenzie, & Christopher Woodruff (2007) Returns to Capital in Microenterprises: Evidence from a Field Experiment, IZA DP No. 2934

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gathered by Invest Founder, Jon Bishop, from a small business in Panama showed a return on capital of around 650%. Consider:

- The business was a mom-and-pop shop that sold general goods such as rice and laundry detergent.
- The owners of the mom-and-pop shop said that they marked products up about 100% compared to the price at which they purchased them.
- The shop owners turned over inventory six or seven times per year.
- The return on capital for these shop owners is therefore around 650%. Stated another way, \$1,000 invested with these shop owners would turn into around \$6,500 by the end of the year. Even if the MFI charged on the high end (50%), that would amount to just \$500 a year, leaving these shop owners with \$6,000 for operating expenses and profit.

When microentrepreneurs are earning such high returns on additional capital, paying 30-50% for credit can make economic sense.

Returns on capital like this do not scale. At loans above a couple thousand dollars, the returns on capital drop precipitously. However, with an average loan size across Invest's portfolio of just \$968, understanding how the return on capital functions is key to grasping why microfinance borrowers can be successful despite the interest rates charged.

Another metric to consider is the repayment rate for microfinance loans. If the interest rates charged were unduly burdensome, we would expect to see a high rate of default among borrowers. However, the average Portfolio at Risk > 30 Days (PAR 30), a measurement of the percentage of the portfolio that is late by more than 30 days, for Invest's MFI partners was 5.25% as of September 30, 2024. That stands in contrast to almost half (46%) of payday loan borrowers in the US who are estimated to have defaulted on their loans within two years of taking them.³ A PAR 30 of 5.25% shows that the vast majority of microfinance borrowers in Invest's portfolio are current on their loans, suggesting that payments of loan principal and interest are manageable.

Invest's microfinance partners strive to make credit available to those at the lower end of the economic spectrum so that they can improve their lives. Making very small loans, particularly to those in rural areas, is quite costly. Microfinance institutions charge rates that cover their operational and financing costs, while providing a modest margin for business growth. For many micro business owners in developing countries, returns on capital are so high that they see clear value in taking out a loan from a microfinance institution. Default rates among microfinance borrowers are low, suggesting that payments are manageable. When considered with this appropriate context, microfinance interest rates in the range of 30-50% per annum appear reasonable.

³ Susanna Montezemolo & Sarah Wolff (2015) Payday Mayday: Visible and Invisible Payday Lending Defaults, Center for Responsible Lending