

Variations in Microcredit Interest Rates

MICROCREDIT INTEREST RATES VARY STRONGLY BETWEEN COUNTRIES

Global differences in microcredit interest rates are dramatic. The global average is about 35 percent, but the average in Uzbekistan is above 80 percent, and in Sri Lanka it is around 17 percent (see Figure 1). Small loan sizes are the most commonly cited reason why microcredit rates are higher than normal bank rates. Microcredit is a “high-touch” business, and microfinance institutions (MFIs) have to process thousands of tiny transactions. But Figure 2, which plots average loan balances against portfolio yields, shows pretty clearly that loan size is only one of the factors that explain the differences between average interest rates.

Where do these considerable differences come from, then? To answer this question, let’s take a look at the main factors that influence MFI interest rates. To illustrate our arguments, we will look closely at two countries from the top and two from the bottom of Figure 1.

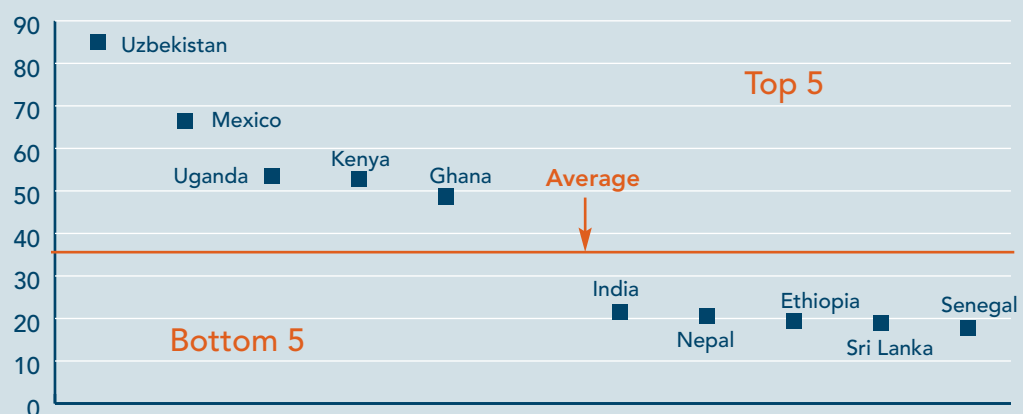
INTEREST RATE DRIVERS: A TALE OF FOUR COUNTRIES

Operating costs

Operating costs always have been the main driver of MFIs’ interest rates because microfinance is a labor-intensive business. According to a forthcoming CGAP paper (Rosenberg, Gonzalez, and Narain forthcoming), operating expenses make up close to 50 percent of nominal interest yields in a worldwide comparison. Not surprisingly, the countries with the lowest interest rates tend to have low operating costs. Such is the case in Ethiopia (where operating costs account for 9.4 percent of the gross loan portfolio) and Sri Lanka (7.7 percent). Nominal interest rates are lower than 20 percent in these countries.

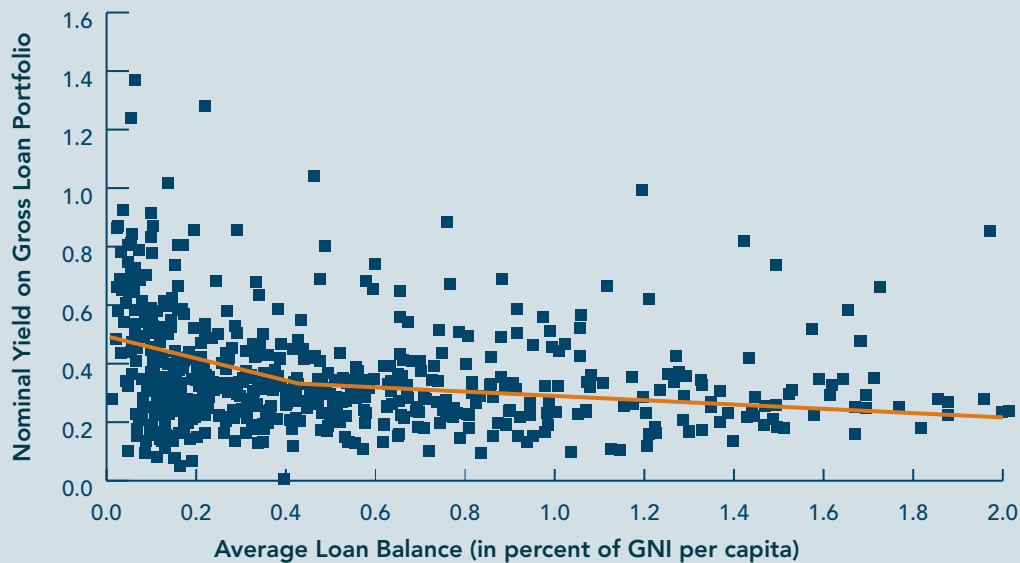
Let us now have a look at operating costs in two countries where interest rates are above 60 percent: Uzbekistan and Mexico. In Uzbekistan, mean operating costs in relation to loan portfolio add up to 39 percent,

Figure 1



Source: Combined MIX Market and MBB database, based on the most recent data available for the years 2005–2006 (if 2006 data were not available, 2005 data were used).
Only sustainable institutions (i.e., ROA >=0)

Figure 2



Source: Combined MIX Market and MBB database, based on the most recent data available for the years 2005–2006 (if 2006 data were not available, 2005 data were used).
Only sustainable institutions (i.e., ROA \geq 0)

which could be because it is a relatively young sector. Gonzalez (2008) shows that for MFIs younger than six years old one additional year in the market is expected to reduce the operating expense ratio between two and eight percentage points. In Mexico, where there is a longer track record of microfinance, high operating costs also can be observed; they account for almost 45 percent of gross loan portfolio. This is probably driven by very low average loan sizes (with US\$387 being one of the lowest in the region [Navajas 2006]) and the comparatively high costs of qualified labor in Mexico. Also, according to industry observers, much of Mexican microfinance serves rural areas with low population density, which may raise transport expenses. Another driver of Mexican interest rates is the high profits of the MFIs.

Public Policy

In some countries, there seems to be political motivation to keep microfinance interest rates below a certain level. As far back as 1998, the National Bank of Ethiopia removed all interest rate ceilings in the financial sector, but a majority of MFIs have chosen to maintain a lower interest rate, which has been partly driven by political considerations (Helms and Reille 2004). Independent observers repeatedly report a palpable pressure from the political arena to keep interest rates fairly low. In Sri Lanka, concessionary loans are being made available to institutions to lend to end clients at capped interest rates of 6 percent and 7 percent (Microfinance Gateway 2005).

In Ethiopia and Sri Lanka, most microfinance activities are carried out by public institutions. These institutions often benefit from overt or hidden subsidies: subsidized cost of funds (for Sri Lanka coming from post-tsunami cheap loans) or in-kind subsidies (in Ethiopia, governmental MFIs get some of their staff paid by local government and are allowed to use rent-free public buildings for operating their branches). Unsubsidized private MFIs therefore face very high hurdles to enter these markets.

A completely different situation can be encountered in Uzbekistan. With a population of 26 million, Uzbekistan's 50 microfinance providers currently serve 60,000 borrowers (compared with neighboring Kyrgyzstan, which has a population of 5 million and 500 microfinance providers who serve 175,000 borrowers) (Gaul and Tomilova 2006). In terms of economic freedom, Uzbekistan's economy ranks 130th out of 157,¹ and independent observers report a dire lack of cash that affects all economic transactions (the premium on cash as opposed to digital money is estimated to be 20 percent). All these factors taken together indicate that MFIs can access a huge and virtually untapped market that is willing to soak up fresh money at almost any price.

Competitive Intensity

So far, there are little reliable data on competition in microfinance markets, which is why we have to rely on anecdotal evidence reported by practitioners in the field. In Uzbekistan, four microfinance organizations had to close with the enactment of an August 2006 microfinance law because they did not meet the newly established legal and regulatory requirements (Asian Development Bank 2008). Some argue that maybe

competition was thereby reduced, and MFIs' price-setting strategies became even more unhampered. Despite the large number of microfinance borrowers in Mexico (the latest MIX Global Figures [www.mixmbb.org] report 2.6 million borrowers), competition seems not to have put palpable pressure on MFIs. Anecdotal evidence from Mexico indicates, though, that recently prices have fallen in certain regions where institutions compete for market share. Also, market observers report that loan pricing has become a more prominent management agenda item than it has been in recent years. Experts expect this trend to gain momentum.

OUTLOOK

Apparently, there is no single, simple explanation for the considerable intercountry differences in interest rates. In addition to small loan sizes, which undoubtedly are an important driver behind interest rates, other dynamics are at work. Our examples have shown that the reasons for differences in interest rates can be manifold and often tend to be highly country specific. Current research has already started to address some fundamental questions:

1. How do borrowers comparably fare in low-interest and high-interest environments?
2. What is the effect of competition on MFIs' efficiency? Does more competition necessarily lead to lower interest rates?
3. How should public policy exert influence on the domestic microfinance sector? What are the features of an "appropriate" regulatory environment?

Better data will be needed to obtain more clarity on these issues.

¹ The Economic Freedom Index is published annually by the Heritage Foundation. The complete ranking is available online at <http://www.heritage.org/research/features/index/countries.cfm>.

Further Reading

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