

Issues in Microcredit Interest Rates

Presentation by

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The logo of the Asian Development Bank (ADB), consisting of the letters 'ADB' in a white serif font on a dark blue square background.

“If you lend money to one of my people among you who is needy, do not be like the moneylender; charge him no interest.”

**The Book of Exodus (Old Testament)
Chapter 22, verse 25**

Outline

- Introduction
- Cost recovery rate formula
- Key issues
- Closer look at the issues
- Conclusions

Introduction

- “Interest rates” : long-standing debate
- Views expressed by economists, religious leaders, etc.
- Difficult to compare interest rates
 - Quoted rates differ from actual rates

Cost Recovery Rate Formula

$$R = \frac{AE + LL + CF + K - II}{1 - LL}$$

Where:

R = rate of interest

AE = administrative expenses

LL = loan losses

CF = cost of funds

K = capitalization rate

II = investment income

(Source: CGAP, Occasional Paper No. 1)

Three Selected Issues

- Do microcredit interest rates have to be necessarily high?
- Can the poor afford high interest rates?
- How can the rates be reduced?

Do microcredit interest rates have to be necessarily high?

- Justification provided by many people:
 - High cost operation
 - Hence, need high interest rates
- High rates enable increased outreach
 - Breadth
 - Depth
- High rates do not compromise outreach



Closer look at the issue

- High cost structure is not an inherent characteristic
- Lack of emphasis on costs
- Lack of emphasis on low-cost business models

Can the poor afford high interest rates? (often 35%-45% per year)

- Justification provided:
 - Many borrow from informal markets at higher rates
 - Cost is less important than access



Closer look at the issue

- Ability to pay is an empirical issue
- Those who can generate high annual returns on investments – yes
- But such opportunities are limited
- Poor require credit for investments which do not immediately improve debt capacity

How can the rates be reduced?

- Remove fat (not meat) in your organization (scope is there)
- Re-examine your business model and improve
- Squeeze inefficiency out
- Move away from exclusive focus on the poorest
- Improve risk management
- Pay more attention to:
 - Innovations
 - Technology
 - HRD

Conclusions

- Cost structures remain high
 - Due to lack of attention
- Must admit high microcredit interest rates deny access to some segments of the poor
- Must admit that rates must be brought down while ensuring sustainability
- We need a fundamental shift in the way we think about microcredit interest rates
- Those MFIs who cannot do this are unlikely to survive in the next decade
- Strategic approach to pricing is needed

For More Information

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