

RESPONSIBLE PRICING: THE STATE OF THE PRACTICE

A draft discussion paper of The Smart Campaign
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Keeping clients first
in microfinance

Responsible Pricing: The State of the Practice

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This paper was prepared for the Smart Campaign Steering Committee by its Task Force on the Evolution of the Principles. It was drafted by Larry Reed, with input and assistance from Alexandra Fiorillo. Special thanks to MicroFinance Transparency (MFT) for the use of material developed by MFT and for guidance on content.

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Executive Summary

In December 2009, The Smart Campaign amended its Client Protection Principle, “Transparent Pricing” to become “Transparent and Responsible Pricing.” The principle states that pricing should be “both affordable to clients and sustainable for financial institutions.” This formulation emphasizes that low prices are good for clients, while allowing for the practical realities entailed in the provision of small loans and low-value savings accounts. In amending the principle, the Campaign affirms the importance of responsible pricing while recognizing that the current state of the practice does not now provide clear guidance or standards to define it.

In order to move in the direction of clearer guidance, the Campaign prepared this discussion paper. It examines the full range of approaches to responsible pricing of loans, from promoting competition, to return on equity limitations, to interest rate caps, to comparative transparency. These approaches are discussed in the context of the cost curves developed by MicroFinance Transparency, which plot detailed information on pricing, terms and conditions among all the (participating) lenders in a country.¹ Among the most important messages to emerge from the MicroFinance Transparency data are:

- Pricing and the cost structures that determine it vary widely from one country to the next. It makes sense to judge institutions in their country setting and against their competitors.
- Small loans require higher—and sometimes surprisingly much higher – interest rates and fees. This argues against interest rate or price caps, which penalize institutions attempting to reach harder-to-serve clients such as poorer people.
- Analysis of individual providers should account for factors such as outreach to (more costly) rural areas, provision of non-financial services, high profits or inefficiency. All of these factors contribute to a final determination of whether pricing is responsible.

The assessment tools developed by The Smart Campaign use the comparative transparency approach, as shown in the on-site assessment guide developed through the Beyond Codes project and available on the Campaign website, “Conducting Client Protection Assessments: A Guide.” This is also the approach advanced by MicroFinance Transparency. While conceptually similar, in that both approaches evaluate pricing in a country context and through comparisons between similar products offered by multiple institutions, the Assessment Guide and MicroFinance Transparency tackle different aspects of the challenge.

Based on analysis of the current state of the practice, the Smart Campaign endorses a continued focus on comparative transparency at a country level. This ongoing work will deepen the industry’s understanding of pricing through data analysis and discussion, and it is hoped that it will eventually enable development of consensus guidelines. In the mean time comparative transparency can serve to exert pressure on organizations to price responsibly because observers will use the data to apply their own standards.

The Campaign plans to develop and/or support tools, in concert with other industry players, notably MicroFinance Transparency, to promote comparative transparency over the coming months. In the longer term, it is also important that the industry make it a priority to learn more about affordability by studying clients. It should also educate investors, clients, and regulators about the factors that contribute to sustainability.

1. [MicroFinance Transparency](#) is a non-profit organization founded in 2008 that collects and publishes pricing information from micro-finance institutions (country by country).

Client Protection and Pricing

The challenge of defining responsible pricing in microfinance recently became a story that drew the attention of the New York Times. “The fracas over preserving the field’s saintly aura centers on the question of how much interest and profit is acceptable, and what constitutes exploitation,” writes Neil MacFarquar. The story goes on to describe cases of high interest rates being charged to very poor people, where the clients, providers, and investors seemed unaware of what the rates really were.²

The question posed by the story is a key one for the microfinance industry to address. Clearly it costs more to make 10,000 small loans of \$100 each than to make one \$1 million dollar loan, so the prices on smaller loans need to be higher. But this has led to a confusing array of pricing techniques and charges that can make it difficult to determine the real price for a loan. And when you combine confusing pricing structures with the power imbalance between a loan provider (who has money available to lend) and a poor person (who needs access to finance in order to earn enough money to provide food and shelter to her family), you have circumstances that supply room for unscrupulous providers to exploit the poor.

The Client Protection Principles of the Smart Campaign seek to help the microfinance industry focus and improve its service to poor clients. In February 2010, the Smart Campaign amended the second of its six principles to include responsible pricing as a key part of client protection. The principle now says (*italics show phrases that were added*):

Transparent and Responsible Pricing: The pricing, terms and conditions of financial products (including interest charges, insurance premiums, all fees, etc.) will be transpar-

ent and will be adequately disclosed in a form understandable to clients. *Responsible pricing means that pricing, terms, and conditions are set in a way that is both affordable to clients and sustainable for financial institutions.*

This amendment came out of a discussion held over several months by the Principles Task Force of the Smart Campaign and was approved by the Campaign Steering Committee and accepted by existing endorsers of the campaign.

We all have innate understandings of what “affordable” and “sustainable” mean. Intuitively, affordable for clients means that clients derive a net benefit from a service even after paying full cost for it. Sustainable for institutions means that revenues raised are sufficient to keep an institution solvent (which means they must generate profits) over a long period of time. It is not at all easy to provide specific guidance about what is and is not affordable or sustainable, as the discussion that follows will demonstrate. Our review of the state of the practice in responsible pricing shows that the microfinance industry has not yet come up with a way to define when a price is both affordable to the client and sustainable for the financial institution, though it has made a lot of progress in that direction over the last few years.

This paper reviews the state of the practice for assessing responsible pricing, describes the current methods that have been suggested by various observers, and reviews some approaches being used or considered by the Smart Campaign. It also gives recommendations for improving the state of the practice in the future. But first, some background on why the whole concept of responsible pricing for small loans may not be as straightforward as it seems it should be.

2. Neil MacFarquar, “Banks Making Big Profits from Tiny Loans,” *New York Times*, April 13, 2010.

Renting Money

The concept behind responsible pricing stirs little controversy. Most people in the financial community agree that pricing terms and conditions should be set in a way that is both affordable to clients and sustainable for financial institutions. The challenge comes in moving from concept to application. How do we determine whether the prices charged by a given microfinance provider meet this responsible pricing standard?

To understand some of the challenges inherent in assessing responsible pricing we need to look a little more closely at how financial services get priced. For most loans and savings accounts prices are set as interest rates. These rates give us a percentage that we will pay or be paid for each unit of currency we borrow or save for a given unit of time.

In this way financial services resemble renting real estate. When you take out a loan you are renting someone else's money for a given period of time and you agree to pay them based on the amount of money you rent and the length of time you keep their money. When you save you are renting your money out to someone else, and they agree to pay you a set amount for each period of time that they have it. This

makes comparing financial products by interest rates similar to comparing real estate rents by price per square foot (or meter).

In real estate, several factors influence both the costs of providing the real estate and therefore the prices charged for renting. These include the costs incurred by the building owner (the purchase cost of the property, financing, maintenance, taxes, etc.), the location of the property, the amenities included with the apartment, the amount of space you want to rent and the length of time you are willing to commit to renting. Similar factors affect the cost of renting money, including the costs incurred by the lender (cost of capital, operating costs, bad debts and taxes), the proximity of the service to the clients, additional services that might be provided (like training or insurance), the amount being lent and the amount of time that it will be utilized.

This comparison of renting money to renting apartments helps explain some of the challenges in assessing responsible prices for money. In the same way that the costs per square foot of real estate vary greatly by location, so the price for money will vary by country and by locations within a country. And just as the per-square-foot price for real estate will

FIGURE 1

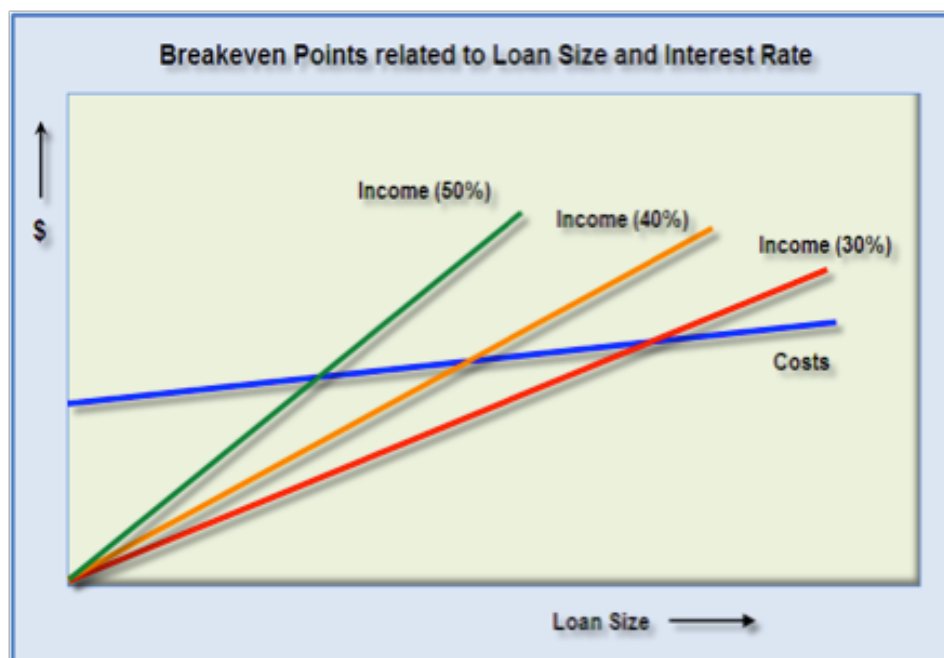
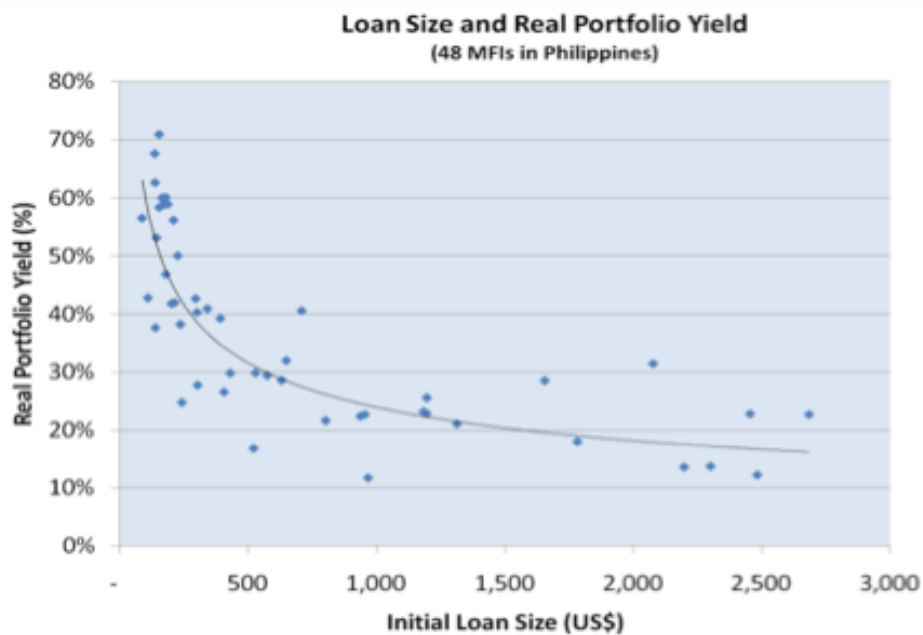


FIGURE 2



increase, sometimes very significantly, as the size of the unit and the length of the rental term decreases, so it is with renting money.

The Cost and Price Curves³

The microfinance industry has long said “The costs of credit delivery are relatively flat—it costs nearly as much to make a \$100 loan as a \$1000 loan. Therefore prices of smaller loans must be higher.” However, the full implications of this have not before been realized. We have long assumed prices are linear, with a gradual slope. Instead, as we will see, prices per dollar loaned really follow a rather steep downward-sloping curve. And, in fact, operating costs follow a remarkably similar curve.

In Figure 1, the x-axis shows increasing loan sizes, while the y-axis shows monetary amounts of income and expense. The blue line in Figure 1 shows relatively flat costs—a very small loan has nearly the same costs as a much larger loan. Income, however, is proportional to loan size. The red line shows the amount of income coming in relative to loan size if

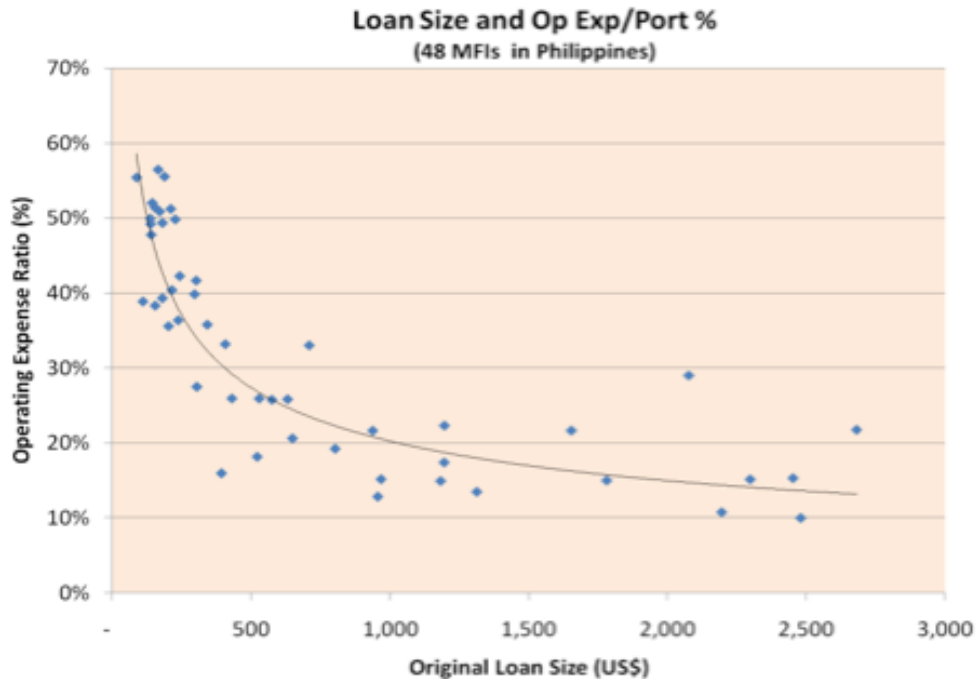
the interest rate were 30%. A very small loan generates little income, but income increases proportional to the loan size. At a certain loan size, the income generated by that loan meets the costs of delivering that loan, and the institution reaches breakeven. At a given price, loans larger than the breakeven amount generate a profit, while smaller loans result in a loss. For an institution to deliver those smaller loans without losing money, it needs to raise the price of those loans, for example to 40%. And the process continues—the smaller the average loan size, the higher the price required to reach breakeven.

Does theory match with reality? Figure 2 shows data for 48 MFIs in the Philippines. Each dot represents the average loan size and the portfolio yield (or average price) for the products of that MFI. Those MFIs delivering larger loans, of around \$2,000, have low portfolio yields of about 20%. Those MFIs delivering loans of \$200, or one-tenth the amount, have much higher portfolio yields, in the range of 40-60%. Data from the 48 MFIs creates a distinct curve showing the correlation of higher prices being charged by those MFIs giving smaller loans.

Likewise, Figure 3 shows a very similar curve for the operating cost ratios of the same 48 MFIs. Those

3. The price and cost curves were pioneered by MicroFinance Transparency. More details and resources can be found at www.mftransparency.org.

FIGURE 3



MFIs with \$2,000 average loan sizes achieve the industry benchmark of 15% operating cost ratio. Those MFIs delivering much smaller loans have much higher operating cost ratios. They employ methods to lower their costs per loan, such as group lending, but the ratio remains high because the denominator in the equation, the loan size, is so low. For example, an MFI can spend \$200 managing a client with a \$1000 loan for a year and achieve a 20% operating cost ratio. If an MFI managing a client with a \$200 loan were to also spend \$200 in operating expenses, it would have a 100% operating cost ratio. Dropping operating expenses in half, to \$100, still results in an operating cost ratio of 50%.

Table 1 uses data from the MIX to give average operating costs for MFIs targeting low-end clients, those serving a broad range of clients, and those serving high-end clients and small businesses. While those serving the low end have the lowest costs to make a loan, their operating cost ratio is almost double that of those that make high end loans.⁴ The end result is that if microfinance providers need to charge prices high enough to sustain their operations, then those making very small loans will need to charge considerably more than those making larger loans. And if

the poorest people also require the smallest loans, this means that the poorer the person, the higher the interest rate they will need to pay if the MFI is to be able to cover its costs. Yet for many observers, this seems unfair to the poor.

Many MFIs, when faced with the need to charge high prices to cover their costs, but also political pressure to keep their prices in line with commercial banks, quote monthly flat interest rates rather than annual percentage rates (APRs).⁵

Approaches to Determining Responsible Pricing

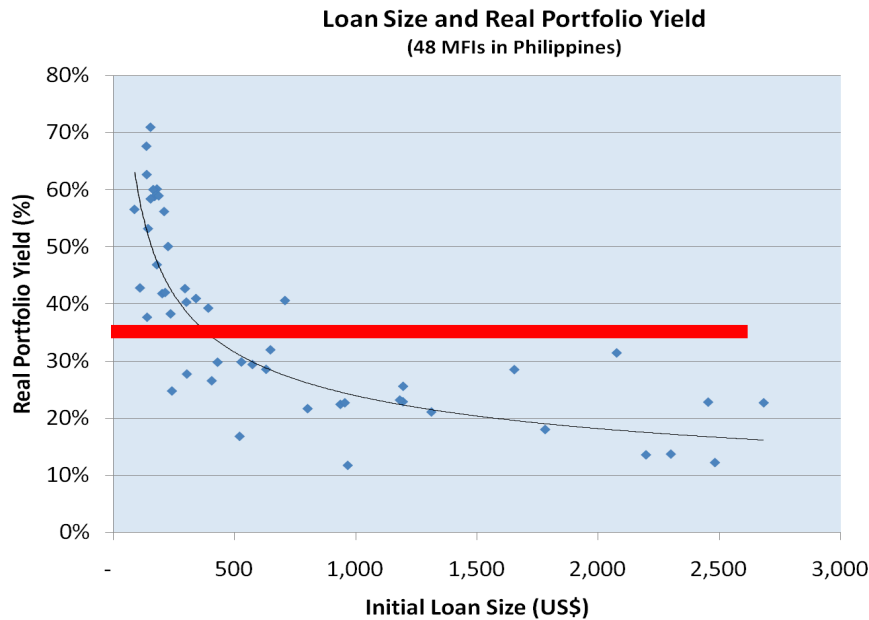
A market where the clients are poor and prices are confusing provides room for predatory lenders to

4. Microfinance Information Exchange, *Microbanking Bulletin*, Issue 18, Spring 2009.
5. In keeping with the Client Protection Principle on transparency, the form in which pricing, terms and conditions are communicated to clients requires a more detailed discussion than space allows here. The Smart Campaign will address this aspect of pricing transparency in other documents.

TABLE 1

| | AVE BALANCE | Operating COSTS % | Loan Loss Provision Expense % | COST LOAN \$ |
|----------------|-------------|-------------------|-------------------------------|--------------|
| Low End | 164 | 25.3 | 1.3 | 54 |
| Broad | 937 | 16.3 | 1.4 | 145 |
| High | 2109 | 13.7 | 0.9 | 222 |
| Small Business | 2,223 | 14.1 | 1.0 | 374 |

FIGURE 4



operate. Governments and other stakeholders in the industry have come up with a variety of methods for protecting clients from price gougers, each with their own strengths and weaknesses. Here is a quick review. Some of the approaches highlighted here are primarily ways to bring prices within responsible bounds. Others focus on determining how to measure or define the cutoff points for responsible pricing. Some methods do both.

Interest Rate Caps – More than 30 developing and transitional countries have instituted some form of interest rate controls or caps as a way of preventing clients of financial services from being exploited. These controls place a ceiling on the maximum amount a financial institution may charge a borrower.

The primary virtue of interest-rate caps is their simplicity. They are easy to understand, and the same standard gets applied to all financial institutions.

On the other hand, this simplicity is also one of the greatest weaknesses of this approach. Interest rate caps apply the same standard to all financial institutions, regardless of their location, type of clients, loan size, or loan term. They end up harming the poor more than helping, by making small short term loans unattractive to financial institutions. One way to understand this is to look at the graph of the portfolio yield curve in the Philippines in Figure 4. Imagine what would happen if the government instituted an interest rate cap of 35% in that country (represented by the red line on the graph). All the providers making loans of under \$500 would either need to go out

of business or start making larger loans in order to earn enough to cover their costs. At the same time, those making loans above \$2,000 would still be able to charge more than double what their competitors charge and stay within the interest rate ceiling.

Studies carried out in both developed and developing countries suggest that the following negative effects could occur with interest rate caps that are unrealistically low:

- The poor have fewer financial services available to them.
- The poor turn to unlicensed or illegal financial service providers for their financial needs.
- Financial service providers exit rural areas where costs are higher.
- Growth rates of institutions serving poorer clients decline.
- Transparency in prices decreases as lenders find ways to skirt regulation by adding additional charges and fees.⁶

Margin Caps: Another method of assessing responsible pricing that takes into account differences in costs between providers is a cap or ceiling on the difference between the underlying costs incurred by a financial institution and the amount it can charge its borrowers. Nobel Prize winner Muhammad Yunus has proposed a version of a margin cap, based on the difference between an MFI's cost of funds and the interest rate it charges. Yunus proposes three categories: a Green Zone which he calls poverty focused institutions whose interest rates are 10% or less above their costs of funds; a Yellow Zone of institutions who charge between 10 and 15% more than their cost of funds; and a Red Zone of money lenders and loan sharks who charge 15% or more above their cost of funds.⁷

6. Brigit Helms, *Access for All* (Washington, D.C.: Consultative Groups to Assist the Poor, 2006)84-85.

Again, this method has the advantage of simplicity. A person only needs to know two numbers in order to determine the reasonableness of a price, an institution's cost of funds and the interest rate it charges. But once again, this simplicity makes it very difficult to apply this standard across a wide range of locations and conditions. A study done by the MIX found that 75% of all microfinance institutions would land in the Red Zone, and that most NGOs with small average loan sizes would end up in this zone. The chief reason for this is that the formula does not take into account differences in operating costs, and in many countries average operating costs of those making small loans exceed the 15% margin allowed in Dr. Yunus' formula.⁸

Return on Equity Policies: Another way to look at responsible pricing is to not look directly at the price, but to examine whether the financial institution is receiving excessive profits from the poor people it serves. The theory here is that if the pricing structure results in very high profits, the same service could be made more affordable without endangering institutional sustainability.

Several institutions serving small and micro businesses have adopted return on equity (ROE) targets as a tool for implementing their commitment to responsible finance. By deliberately setting an ROE target, they hope to manage in this manner the tension between institutional profitability and institutional mission. For example, the ProCredit group has set an ROE target of 15%.⁹ Equitas in India has an ROE target of 25%, which, according to its managing director P.N. Vasudevan, is above prevailing returns in the Indian finan-

7. Muhammad Yunus, *Creating a World Without Poverty* (New York Public Affairs, New York, 2007) 96.

8. Adrian Gonzalez, "Analyzing Microcredit Interest Rates," MIX Data Brief No. 4 (2010) (<http://www.themix.org/publications/analyzing-microcredit-interest-rates-review-methodology-proposed-mohammed-yunus>)

9. Hennig, Peter, "ProCredit Banks in Southeast Europe: Successful Public-Private Partnership in Microfinance," in *Microfinance Investment Funds: Leveraging Private Capital for Economic Growth and Poverty Reduction*, Ingrid Mattäus-Meier and J.D. von Pischke, eds., Springer, 2007

TABLE 2

| | Total Clients | Loan Bal/ Borrower | Port. Yield | Op Exp/ Portfolio | Cost per borrower | Clients /Staff | ROE |
|-------|---------------|-----------------------|----------------|----------------------|----------------------|-------------------|--------|
| MFI 1 | 12,276 | 224 | 66.53% | 48.30% | 100 | 123 | 13.64% |
| MFI 2 | 49,308 | 263 | 51.00% | 25.84% | 62 | 223 | 33.13% |

cial sectors, but below what Equitas could earn.¹⁰ Using these institutions and others as examples, the SEEP Network has begun a conversation with its members about this alternative.

Using ROE targets as an approach to look at responsible pricing has several advantages:

- A CGAP study on MFI interest rates analyzes the effect of eliminating all profits to assess the sensitivity of interest rate changes. It states that “at the upper percentiles [of profitable MFIs], especially the top 5 percent, ... interest rates could be shaved by almost two-thirds.”¹¹ At the same time, it argues that limiting profits would have little effect on the bulk of institutions with moderate interest rates.
- It accounts for differences in operating costs and costs of funds between countries and between locations within countries by using profitability (as measured by Return on Equity) as its gauge. In this way a financial institution serving poor customers (with high costs and a higher interest rate) could earn the same ROE as a financial in-

stitution serving much larger clients (with lower costs and lower interest rates) and still be considered responsible.

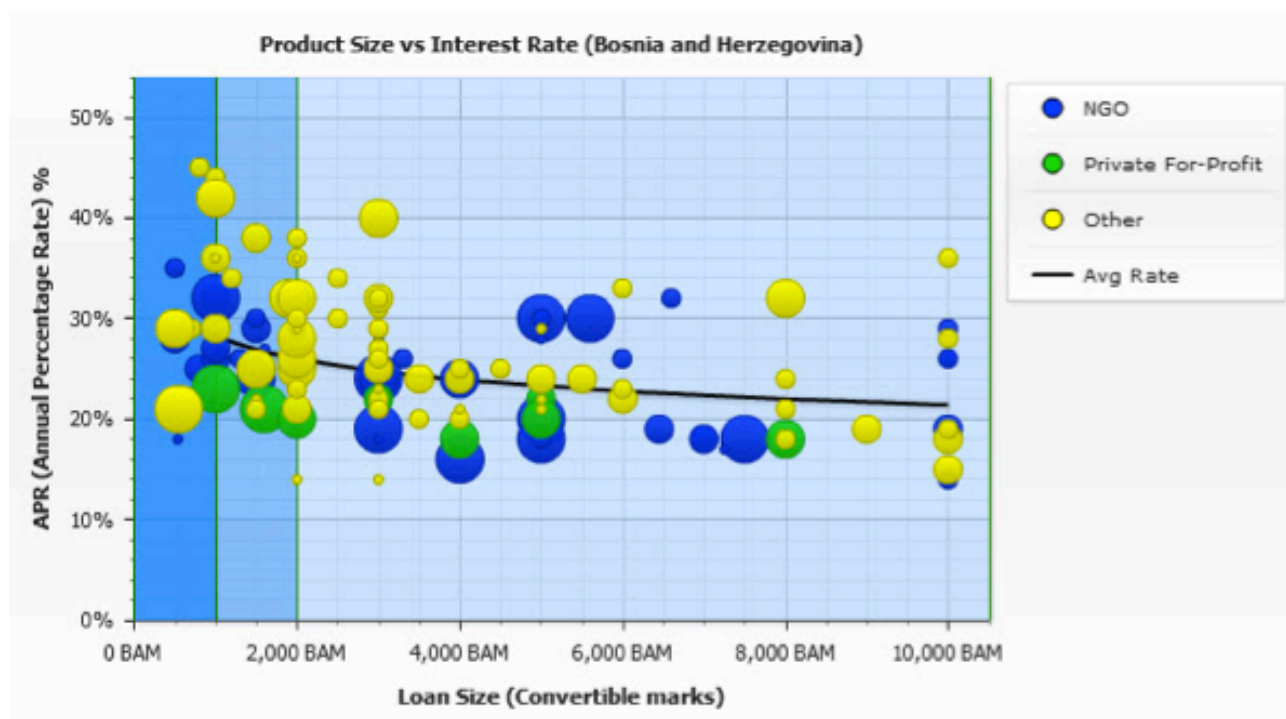
- It gives a number that is comparable across different types of financial institutions and is relatively simple to calculate and understand.
- MFIs can set their ROE targets at a level that is consistent with their institutional mission. This can include a target which will help them attract additional capital to fuel their growth.
- MFIs can manage to an ROE goal and adjust prices or add additional services in order to stay within that target.

This approach also carries limitations as a tool for measuring responsible pricing. First, it could obscure inefficiency in financial institutions. Take, for example, the two MFIs depicted in Table 2 below (this is actual data for two MFIs located in the same country). Both MFIs make loans to very poor people using a large group-lending methodology. MFI 1 earns an ROE of 14%, while MFI 2 earns 33%. Does this mean that the prices of MFI 1 are more responsible than those of MFI 2? Not necessarily. Based on the Portfolio Yield numbers, it looks like MFI 1 charges its clients more on average (66%) than MFI 2 (51%). MFI 2 is able to charge lower interest rates to its clients and still earn an ROE of 33% because

10. Comment from Vasudevan Pathangi Narasimhan, founder of Equitas, in the CGAP Virtual Conference on Responsible Finance, April 12-13, 2010

11. Richard Rosenberg, Adrian Gonzalez, and Sushma Narain, *The New Money Lenders: Are the Poor Being Exploited by High Microcredit Interest Rates?* CGAP Occasional Paper 15, 2009, <http://www.cgap.org/p/site/c/template.rc/1.26.5302/>

FIGURE 5



its greater scale has enabled it to become more efficient (it has an Operating Expense Ratio of 26% vs. 48% for MFI 1).¹²

Other weaknesses of this approach include:

- An MFI which sets an upper limit on its return on equity could discourage commercial investors from investing in it.
- The limit does not differentiate in how the profits of the MFI are used. In some cases greater profits are used to provide additional benefits to existing or new clients that don't show up as expenses. Credit unions

and other client-owned institutions return their profits to their clients. Most MFIs retain some, most or all of their profits and use them to expand the number of clients they can serve.

- This approach would not apply to large commercial banks that serve many different client segments beyond microfinance.

Comparative Transparency: Another approach to responsible pricing avoids the setting of ceilings or limits and instead advocates for a public listing of the prices for all microfinance products in a country, using a common method for defining the price. The leader in advancing this method is MicroFinance Transparency. This organization goes country by country to collect data on every microfinance loan (and sometimes savings) product offered in the country, calculates an annual percentage rate (APR) and effective interest rate (EIR) on these products and then posts this information on its website. MicroFinance Transparency takes into account the effect of loan size on operating costs

12. MIX Market, Country Profile Page "Microfinance in Peru," http://www.mixmarket.org/mfi/country/Peru/calculation_usd.average_balance_borrower%2Ccalculation_usd.cost_per_borrower%2Cbalance_sheet_usd.gross_loan_portfolio%2Cproducts_and_clients.total_borrowers%2Ccalculation_usd.operating_expense_loan_portfolio%2Ccalculation_usd.return_on_equity%2Ccalculation_usd.yield_on_gross_portfolio_nominal/2008/.

by showing the rates on a graph that depicts each loan product plotted by its cost (expressed as APR or EIR) and average loan size. Figure 5 shows the market for microfinance loans in Bosnia and Herzegovina. Each circle represents a loan product. The size of the circles represents the number of clients receiving each product. The colors represent the different types of legal entities making loans (NGOs, private for-profit companies and other).¹³

This graph produces a market price curve and makes it easy to see which loan products carry prices that are far above the market average for those sizes of products. The graph does not distinguish between loan purposes (education, housing, business, consumption, etc.), but that information is available in the detailed description of each loan product, as well as the range of loan terms and the percentage of loans made in urban and rural areas.

MicroFinance Transparency does not make a determination on whether the price on a given loan product is responsible or not, but the data it generates and displays on its website does make it easier for regulators and investors to make their own assessments.

The MicroFinance Transparency tool advances the cause of assessing responsible pricing in several ways, including:

- Using a common definition of price (APR or EIR) to compare loan products that puts all the different methods of charging interest and the accompanying fees into a single number.
- Providing information on each loan product, rather than averages like Portfolio Yield which may blend together high cost and low cost products.
- Showing the information differentiated by loan size, so that those making more costly small loans do not get penalized.
- Collecting information on all loan products for a single country at one time, making

comparisons easy while also helping MFIs feel safe in reporting their data.

The data generated by MicroFinance Transparency may lead to downward pressure on interest rates in a country in the following ways:

- MFIs will be able to see the APRs of their own products and how they compare with others in the market. This may cause those who are significantly above the market curve to reduce their prices.
- Regulators will be able to identify those who charge rates significantly above the market for a given loan size and put pressure on them to lower prices.
- MFIs charging lower than market rates may advertise this fact to potential clients, causing other providers to lower their rates in response.

This approach also carries weaknesses, some of them based on the approach itself and others because the concept is still new and needs to be implemented more widely before its effects can be fully realized. Some of the weaknesses include:

- The process of collecting data is long and labor intensive. At the time of this writing, MicroFinance Transparency has data for only three countries on its website. It may take a long time before data of this type becomes available for the majority of microfinance institutions.
- The data provide good point-in-time information, but we have yet to see whether the data get updated regularly and remain accurate over time.
- Microfinance clients will not have ready access to this data when purchasing financial services.
- Showing comparative data may not help much in assessing responsible pricing in

13. See <http://mftransparency.org/data/countries/ba/data/>.

markets where there are few providers who charge similar prices.

Promoting Competition: Another approach to encouraging responsible pricing is to promote competition between the providers of microfinance services. With strong competition, market forces can lead to innovation that brings better products and/or lower prices. The microfinance market in Bolivia provides a good example. In 1992 BancoSol, one of a very few microfinance loan providers in the country at the time, charged an annual rate of 65%. Today, in a much more competitive environment with many more large microfinance providers, and with the introduction of required price disclosure, BancoSol charges an annual rate of 22%, which is similar to the rates charged by its direct competitors.¹⁴ Worldwide, as microfinance has become more popular and many more providers have entered the market, average interest rates dropped at a rate of 2.3% per year from 2003 to 2006.¹⁵

Competition gives clients more power by giving them options. It can provide an efficient and enduring way to encourage the providers of financial services to price and act responsibly. However, mature competitive markets can take a long time to develop. In addition, in an age of IPOs and stock options, market forces can also encourage financial service providers to maximize short term profits over long term sustainable relationships with clients. This has been the case recently in India, where intense competition has led to a rapid increase in clients (from 1 million in 2002 to 15 million in 2009). While the market theory would suggest that this increasing competition would lead to a decrease in prices, the opposite has been true. Average portfolio yield has increased from 19% in 2002 to 31% in 2009. M-CRIL, an Indian microfinance rating agency, suggests that this increase in price has been driven by some of the country's largest MFIs seeking to increase profits in order to boost their equity valuations.¹⁶

14. Helms, *ibid.*

15. See <http://www.cgap.org/p/site/c/template.rc/1.26.5302/>.

16. See *M-CRIL Microfinance Analytics*, <http://www.m-cril.com/BackEnd/ModulesFiles/Publication/M-CRILMicrofinanceAnalytics2009.pdf>.

Smart Assessment: The Beyond Codes Indicators Approach

As a part of its work to encourage consumer protection practices, the Smart Campaign conducts voluntary on-site assessments of MFIs' performance against the Client Protection Principles. This includes an assessment of responsible pricing. The assessment tool (available on the Smart Campaign website as "Conducting Client Assessments: A Guide") was derived from the Beyond Codes project.¹⁷ It uses a market-wide approach, looking at several factors and comparing them with other providers offering similar products in similar locations. Specifically, the Smart Assessment:

- Calculates the APR for each loan product and, when the information is available (i.e. in a country where MicroFinance Transparency has collected this data, or where it is required by the Central Bank), compares this with the APRs of similar products from competitors.
- Uses published data to compare the Operating Expense Ratio, Portfolio Yield and Return on Equity of the financial institution with other providers in the country.
- Analyzes other data on clients, services and locations to determine how these impact the underlying costs of the institution.

With this information, the assessor uses her judgment and contextual knowledge to assess the MFI on the following indicators. These indicators examine responsible pricing from a variety of angles, implicitly applying several of the approaches described above. "Conducting Client Assessments" directs assessors to consider the following guidelines as they review pricing policies:

17. See "5. Conducting Client Assessments: A Guide" for the full guide; See "1. Getting Started Questionnaire: Client Protection Self Assessment for Microfinance Institutions" to see only the list of indicators. Both tools can be found at <http://www.smartcampaign.org/component/taxonomy/term/list/37/12>.

- Prices are not subsidized, are market oriented, and competitive within the country context.
- The financial institution does not charge customers for its own inefficiency, as demonstrated by a comparison of efficiency and profitability ratios of similar competitors.
- The institution earns a reasonable rate of return to support operations and grow, while allowing the customer to do the same.
- The financial institution invests a major portion of its profits to increase value to customers, such as lowering interest rates or adding or improving products and services.
- Pre-payment penalties or account closure fees and other penalties are not excessive. For example, they would not prevent a customer from changing to another product or provider, or unreasonably compound debt.

An analyst could take other factors into consideration before making a final judgment. For example, if an institution was growing fast to reach underserved areas or market segments, higher prices might be justified, while if it pays unusually high executive compensation, the analyst's final judgment might be tougher.

While this approach does take into account country context and other factors that affect price, it also has limitations, including:

- The standards upon which the assessment is established are not determined, but depend on the assessor's judgment.
- Where APR data is not available for other microfinance providers in the country, this process can only use portfolio yield as a comparison, which is not as precise a measure.
- There is no overall standard that applies to all countries.

- Since this approach uses market comparisons within a country, it may not be effective in countries where few providers offer similar products that are appropriate points for comparison.

Advancing the State of the Practice: Towards Consensus Guidelines

Next Steps for the Smart Campaign. At present there are no agreed *standards* as to appropriate credit pricing levels to guide an assessment of responsible pricing. Standards can only emerge over time, as the microfinance sector continues to delve into this issue, and in particular to examine pricing data. (Since pricing standards should account for differences in product features, provider type and other contextual factors, we should not expect to end up with a single standard.) Nonetheless, there has been a good deal of recent progress on the responsible finance concept and *methods* for assessing responsible pricing.

Given this state of the practice, the Smart Campaign endorses comparative transparency methods for assessing responsible pricing. That is, the Campaign commends further development of assessment methods that use standardized measures to compare the pricing of providers within a country. The key elements of this approach are:

- In the absence of consensus standards, observers (whether, clients, regulators, investors or competitors) will apply their own judgment and implicitly, their own standards.
- They should be enabled to do so, as this process will promote transparency and exert pressure on MFIs to price responsibly.
- The best way to enable observers to apply their own judgment is through ready available pricing data that uses a standardized formula or standardized indicators and comes from a growing pool of diverse providers.

- The eventual development of consensus standards will be enabled by comparisons of similar products and institutions. This requires country-based analysis, as well as accounting for factors such as loan size, rural focus, application of profits, etc.

As a follow up to this paper the Smart Campaign will work with MicroFinance Transparency, the MIX and interested industry stakeholders to analyze data and develop tools for evaluating pricing with the aim of making it easier for industry participants to assess the reasonableness of prices easily and quickly. Tools will be developed that can be used by MFIs to assess their own prices against their peers and by associations, networks, and funders to determine whether MFIs meet their specific responsible pricing criteria. For example, the Campaign will explore approaches such as country-based indices that incorporate the criteria used in the Beyond Codes assessments or yellow-flag systems that make it easy for an observer to spot outliers that require closer examination.

Longer Term Steps for the Industry. To gain wider understanding of what responsible pricing means in microfinance, and to improve our ability to assess a financial institution's pricing practices, the stakeholders in the industry (providers, donors, investors, regulators, and researchers) will need to take on a number of challenges.

Require pricing disclosure utilizing a standard formula (regulators and associations): All financial institutions should state the cost of their loans, including all additional charges and fees, using a common format such as APR, EIR and/or Total Cost of Credit. Where conditions permit, this information should also be made available to clients. Regulators should require this information from all microfinance providers, networks should require it of all their members, and investors should request it from all their investees.

18. Daryl Collins, Jonathan Murdoch, Stuart Rutherford, and Orlanda Rithven, *Portfolios of the Poor*, (Princeton University Press, 2009).

Educate stakeholders on the cost curve: Most financial textbooks do not deal with financial services for very low income clients, and therefore most people who set financial regulations are not aware of how steeply the cost curve can rise when loan sizes are very small. This can result in regulation that inadvertently cuts poor people off from needed financial services. More training needs to be provided to regulators, politicians and financial journalists to help them understand and communicate how costs and interest rates work at this end of the market.

Promote client level education on comparing loan products: Once a standard disclosure formula has been established in a country, MFIs and the government should develop education for clients to help them understand how to compare loan products and assess which are best for their own needs.

Learn more about client level ROI: While much is known about the returns earned by microfinance institutions, very little is known about the returns earned by the clients. An interest rate of 50% may seem high to many, but if the clients earn 100% or more from investing the money, then the price seems more reasonable. The book *Portfolios of the Poor* and the ongoing financial diaries studies have begun to show us the creative and complex ways that people with very low and unpredictable incomes manage formal and informal financial instruments to meet their needs. Further analysis of this data can help us get a clearer picture of what makes the prices of financial services affordable or unaffordable for the poor.¹⁸

Promote competitive environments: In the long run, healthy competition with appropriate oversight can drive innovation that lowers costs and improves the range of financial services offered to microfinance clients. In order to prevent this competition from leading to over indebtedness, though, the competition needs to be accompanied with the inclusion of microfinance clients in national credit bureaus. Regulators need to develop frameworks that help lower barriers to entry in this field. Donors and investors should look at whether their investment decisions help expand or diminish healthy competition in a microfinance market.

Concluding Note

Responsible pricing, like the other Client Protection Principles, makes good business sense in the longer run. With the relatively high cost of acquiring new clients in microfinance, financial service providers survive based on long term customer relationships. Setting a price that allows the client's business to thrive helps to generate more future business for the financial institution. Making responsible pricing a key part of the Client Protection Principles, and developing appropriate ways to assess its implementation, benefits both microfinance clients and the financial institutions that serve them.