

Proparco's assistance to the development of the microfinance sector is in line with its strategy to support financial systems in developing countries. At the end of June 2009, Proparco had committed some 50 million euros to finance microfinance projects. Drawing on this experience, Élodie Parent, an investment officer specialized in the microfinance sector, analyzes in this article how the interest rates charged by MFIs are calculated and puts forwards solutions on how to optimize them while maintaining a moderate profitability.

# Striking a balance between affordable rates and satisfactory profitability in microfinance institutions

*The interest rates charged by microfinance institutions (MFIs) are calculated on the basis of their financial situations and profitability targets. To make these rates more affordable for their low income clients, MFIs can conduct an analysis of their financial situation using four key criterias – the aim is then to optimize them. MFIs' profitability targets are set by their shareholders and could be better assessed and more transparent – this can ultimately lead to a readjustment that will bring down rates while maintaining an “adequate” level of profitability.*

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Élodie Parent began working at Agence française de développement in 2004 in Morocco where she was in charge of developing microfinance activity. She is now an investment officer at Proparco where she coordinates the microfinance unit which has committed some 50 million euros of financing to the sector.

Microfinance institutions traditionally target people that are “vulnerable” because they come from the poor populations of a country. Yet the interest rates on the microfinance loans that are extended to them are often high: although the median stands at 26% a year, the average is more in the region of 35%. This apparent contradiction – poor populations, high rates – gives rise to a lively debate on the level of interest rates in the microfinance sector.

The interest rates charged by a MFI are mainly calculated on the basis of its financial situation and profitability targets<sup>1</sup>; to get a better understanding of the levers it can use to lower them, it is first and foremost necessary to analyse its financial model. The second stage involves examining the profitability levels of MFIs. Indeed, it is estimated that the 10% of the most profitable MFIs have a return on equity (ROE)<sup>2</sup> of over 34%; this figure must be compared with the average bank ROE<sup>3</sup> which is below 18%. This issue has become particularly sensitive in the context of the current financial crisis, and the first signs of a possible bursting of a “microfinance bubble”. The situation is made even more complex by the arrival of the private sector which, while channelling increasing amounts of capital towards MFIs, sets them profit constraints that are higher than those of donors. All these reasons clearly explain why the issue of profitability levels is so important. Finally, once the issue of both “affordable rates and sufficient profitability” has been addressed, it is necessary to specify what balance there can be between them.

## Financial performance: a requirement

MFIs have some levers at their disposal that they can use to offer more affordable interest rates; by using them they do not make their clients pay the price of non-optimal management. Cases of “abuses” are not unusual and are encouraged by the lack of regulation and client protection, but also by a lack of available data on the extent to which the profitability of the microenterprises financed is sensitive to the rates charged.

The analysis may first aim to identify and isolate factors that MFIs have no control over. For example, the macroeconomic environment has a direct impact on the financial structure of a MFI and it cannot escape this; the cost of human resources aligned with local standards of living, the cost of refinancing, or the status and taxation that apply to MFIs are consequently factors that it cannot control. As these exogenous factors have a direct impact on its financial performance, the MFI will have to charge rates that are high enough to cover its costs relating to “structural” constraints.

Once these exogenous factors have been identified and isolated, the only way to identify the actual levers the MFI can use to improve its performance is through a financial analysis. One possible financial approach involves focusing the analysis on four key elements that make it possible to conduct a rapid assessment of a MFI's performance whatever its status. This approach is simplified and highlights the key points – the analyst must of course also make a more in-depth analysis. The level of

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rates charged to the clients can – theoretically – be justified when the four objectives are reached or about to be reached.

- The share of the loan portfolio (as a percentage of total assets) devoted to financing income-generating activities for microenterprises and, possibly, VSEs and SMEs must be above 70% of the total balance sheet. This ratio indicates that the MFI is focusing on its core business which is its most profitable activity.

- Its portfolio must be of sufficient quality with a PAR30<sup>4</sup> below 3% in general and at a maximum of 5%. Indeed, the PAR of MFIs that have a bank status stands at 2% and for the 45 biggest MFIs at 3.7% at the end of 2007. The main area of expertise of a MFI remains its sound knowledge of its clients; when it moves away from this, it takes a risk and causes provisions to put pressure on its profitability.

- The cost of financial resources (equity, debt, deposits) must be optimized by trying to give priority to deposits, which are often the cheapest resources. If this is not possible, a MFI should optimize the debt/equity leverage effect in order to avoid financing growth exclusively at the exorbitant cost of accrued income. Indeed, in this case it can only achieve a sufficient level of net income by charging high rates, which in turn will raise the level of equity so as to boost growth – or at least not to curb it. The weight of the return on capital – dividends – must be a specific focus. It will be more difficult to bear if the debt/equity ratio is not optimized.

- Operating expenses, which are by nature high<sup>5</sup>, must be controlled. The aim is not to try to reach bank operating ratios at all costs – this could easily lead to a loss of control (too many clients per loan officer, increase in the unit amount of loans without checking how the funds are used, etc.) – but simply to rationalize certain costs when this makes sense.

All of these criteria must of course be analyzed in the light of the local economic context. But any inefficiency relating to one of them will put a strain on the profitability of a MFI. This will au-

tomatically raise its interest rates to allow it to maintain a sufficient level of profitability. This increase may be a real temptation, since clients are not always aware of it (by lack of education, lack of communication by the MFI). Some studies, including that of Karlan and Zinman (2008) or of Porteous (2006), confirm that there is a relatively low level of elasticity of client demand in terms of the rates charged.

## Profitability level: a rigorous monitoring

Once the performance of the institution has been analyzed and optimized, the next step is to look at the other factor which has a decisive effect on the rates charged: the MFI's profitability target. It is set by the shareholders and must meet both their own profitability targets and also the institution's need to strengthen the equity of the structure. Today it does not seem clear how the level of profitability expected by shareholders is defined. Yet when the issue is to choose between transferring a financial advantage to clients (by improving performance for example) and increasing profitability for shareholders, a natural trend prevails: the exclusive quest for profit. This sketchy area can only be dealt with by designing and implementing specific tools and defining levels of profitability in a more rational manner.

Each MFI could begin by analysing the sensitivity of ROE to the overall effective rate (OER) – which includes all the direct costs relating to the loan – charged to its clients so that the shareholders can be aware of the leeway they have to adjust the rate charged to the client more accurately in line with their profitability strategy. For example, in 2006, if Compartamos had simply kept ROE at 15% instead of 56%, it could have lowered the rates charged to its clients by 29% (they would have fallen from 85% to 56%). In view of the stakes involved in serving the poorest populations, ROE could also be managed by the type of product offered according to the target client base.

Moreover, it would seem that benchmarks are required for MFIs' levels of ROE. The comparison with the banking sector is enlightening, but can only be made in the case of mature MFIs that have been profitable for several years and have an activity that has reached a certain critical size. The

<sup>1</sup> For the sake of simplicity, the "competition" aspect which can exert pressure on rates to be lowered has not been included.

<sup>2</sup> ROE indicates the level of profitability of equity capital; it is measured as the ratio between net income and equity capital.

<sup>3</sup> This is the average ROE of banks in countries that have at least one MFI registered on the MIX Market microfinance portal ([www.mixmarket.org](http://www.mixmarket.org)).

<sup>4</sup> The "portfolio at risk over 30 days" (PAR30) corresponds to outstanding loans with a maturity overdue by over 30 days.

<sup>5</sup> For the 45 biggest MFIs, average operating expenses as a percentage of the portfolio stand at 19.4%, against 7% for banks.

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average ROE of banks in countries that have at least one MFI registered on the microfinance MIX Market portal stands at roughly 18%. This average bank ROE is higher than the average ROE of MFIs in these same countries which stands at 13% (2006). This observation may initially appear “counter-intuitive”. MFIs register a net interest margin four times higher than banks (24% against 6% for banks) and their portfolio is generally of an excellent quality. If the considerable weight of MFIs’ operating expenses partly explains why ROE is lower than in banks, this situation would appear to be mainly due to the fact that proportionally they have more equity than banks. In other words, their debt/equity leverage effect is lower.

On the basis of this observation, the analyst must adjust a MFI’s solvency ratio<sup>6</sup> so that it tends towards that of local banks in order to make the ROE of the two sectors comparable. In view of the social mission of a MFI, it could be considered that the adjusted ROE of a mature MFI should generally be lower than the average ROE of the relevant country’s main banks. If a MFI had a much higher ROE than local banks it would be necessary to try to understand why. However, within a group (like ProCredit or Advans), ROE can be managed at a consolidated level. In this case, as the profitable subsidiaries can “subsidize” the most fragile, ROE can be locally higher than that of banks established in the same country. Whatever the case, it is always essential for a MFI to conduct reflection on its ROE targets and the subsequent rate policy. This is always a constructive exercise for a MFI and its shareholders, particularly in order to justify the investments being classed as socially responsible assets.

## To preserve an instrument to combat poverty

All microfinance players – both donors and the private sector – declare that they are convinced that it is important for MFIs to continue to be a tool to combat poverty. Faced with such a consensus, stakeholders must conduct an in-depth reflection process that will allow them to establish a “fair” rate to charge clients based on “moderate” profitability. This process is all the more important because we are aware of the risks of overindebtedness that are intrinsic to the sector and of the poorest being decapitalized. Donors and the private sector must continue to develop partnerships so that a common approach to investment in microfinance can be built, while respecting their respective risk management constraints and profitability targets. ●

## Comparison between average ROE of banks and MFIs

	AVERAGE ROE (%)	
	BANKS	MFIs
Average MIX-listed countries	18	13
Average Africa	19	17
Côte d'Ivoire	13	-
Ghana	38	13
South Africa	21	-
Central and Southern America	15	17
Mexico	20	20
Bolivia	15	14
Colombia	18	9
Central Asia and Caucasia	6	20
Georgia	10	17
Mongolia	15	22
Southeast Asia	10	43
Cambodia	25	14
Vietnam	17	2

*The regional averages for banks are calculated using the 500 main private banks. The national averages are calculated using the country's 10 most effective private banks. The averages for MFIs are calculated using a sample of data tracked by CGAP.*

*Sources: Bankscope and CGAP (2007-2008 data) and author's calculations.*

<sup>6</sup> Solvency is measured as the ratio of equity to total assets at risk.

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