

Interest Rate ethics: an aspect of social performance in microfinance

Arvind Ashta¹

Chairholder in Microfinance, Burgundy School of Business, CEREN

Abstract

Interest rate ethics question have come to the fore. In this paper, we examine related questions of governance to see whether governance is also related to the ethical question. We then look at a related field of transparency of interest rates. Based on these, we then offer some possible ways for microfinance rating firms to include these issues in their rating criteria. Finally, we offer directions for future research raised by this paper.

Keywords: microcredit, microfinance, rating, double bottom line, ethics, interest rate

I. Introduction

A key question which has been debated in Microfinance in recent years has been interest rate levels. Very often, this question is related to governance. Another major concern has been that the sector is transforming from donor dependence to social investing and the latter group of investors are focusing on a double bottom line. This paper sees how interest rates, specifically, can be included in the social performance metrics.

The plan of this paper is as follows. First we start with a recent case study which has brought the interest rate ethics question to the fore. We then examine related questions of governance to see whether governance is also related to the ethical question. We then look at a related field of transparency of interest rates. Based on these, we then offer some possible ways for microfinance rating firms to include these issues in their rating criteria. Finally, we offer directions for future research raised by this paper.

II. The Compartamos Case and the interest rate question

In 2007, Compartamos made an initial public offering which shocked the world in more ways than one. First, its IPO was oversubscribed 13 times and this showed to the world, that commercial investors were really interested in investing in this field. Second, the valuation

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of the IPO which capitalized the company at 1500 million dollars compared to a book value of 126 million dollars indicated that the company had very high expected growth rates and highlighted that microfinance has been growing at a pace of 30% per year and that commercial operators were growing faster. Third, the book value of 126 million dollars in 2006 compared to a paid-in share capital of 6 million dollars in 2000 when Compartamos was converted to a for-profit company showed a year-by-year doubling of the company, a growth rate made sustainable by high internally generated profits and no dividends in the first few years. This indicated clearly that a microfinance company could be managed following private equity holding models, even when the holders of the equity are predominantly NGOs and developmental bodies such as the IFC.

The fourth, perhaps biggest shock, of course, was unfavourable, when it was discovered that the high profits came from high interest rates neighbouring 100% per annum. The world wondered if this was microfinance and if it was ethical (Lewis, 2008; Smith & Epstein, 2007).

Compartamos, the CGAP, related to one of the donors, as well as Accion, another donor came out quickly with well worded defences (Danel & Labarthe, 2008; Rhyne & Guimon, 2007; Rosenberg, 2007). In short, they argued that the good points of the company and its high profits attracted commercial funds to this sector and that this was positive. They relativised the interest rates of Compartamos indicated that the 100% interest rates included VAT and therefore the actual rates were only about 86% per annum. Although high for a microfinance company in Mexico, these interest rates were much lower than those of consumer credit companies and moneylenders. Moreover, the high interest rates ensured the high growth rates enabling an increased outreach to other poor potential borrowers. Thus, sacrificing the existing borrowers was necessary to enable even poorer people without access to be served.

The critiques pointed out that in the Grameen model, the profits from the interest rates are shared with existing borrowers because part of the interest rate is used to give the existing borrowers shares in the company (Ashta & Bush, 2009; Hudon & Ashta, 2009). Therefore, it was not necessary for private investors to pocket all the gains: they could have been shared with the existing borrowers while permitting the company to grow as fast. Thus, the governance question was strongly interlinked with interest rate ethics.

Another defence often raised is that existing borrowers are making more than 100% profits and this justifies the high interest rate because it shows that existing borrowers are able to repay at these rates. This argument suffers from basic problems stemming from a confusion regarding timing of the decision. At the time of taking the loan, the lender is almost certain to get his fixed income of 100% since he knows default rates are low owing to various contractual terms and group based pressures. As opposed to this, the micro-entrepreneur takes the loan with an expectation, and not a certainty, that he will make a return of more than 100%, thus allowing him to repay the loan. In actual fact, some percentage of people will successfully earn more than a 100% return and the others less than 100% return.

For those who earn more than 100% return, they have of course benefitted, but the impact on them would be greater if they had got a lower financing cost. For those who earn less than 100% return, clearly they should default but microfinance group based and other pressures force them to borrow more from the same MFI or other MFIs to repay their loan to maintain their credit histories. Thus, entrepreneurs who could have been successful at 50% interest rates are forced to make losses and get into over-indebtedness and the argument that they reimburse the loan is not a valid argument to indicate that they are successful.

Thus, although the question of impact is subject to a lot of debate in the microfinance literature, it is clear that impact on successful existing borrowers would be greater if their financing costs were lower, whether they are able to meet their profit expectations or not.

In any case, the attention from all this debate has led to determining what real interest rates are and the CGAP (Rosenberg, Gonzalez & Narain, 2009) finds that average interest rates are about 28% per annum and that although these vary from region to region, Compartamos is clearly an outlier, even in Mexico.

The social performance question therefore needs to examine the interest rate levels in the country. This aspect will be developed in the recommendations section.

III. The governance question: For-profit or not-for-profit and those who change horses mid-stream

Further examination revealed that Compartamos NGO, which floated the private for-profit company, had initially received donor funds. These donor funds had undoubtedly been used to create awareness and brand equity which was finally used for the benefit of the for-profit company and its owners. These owners included not only the NGO and the development bodies but also private individuals. This was a further shock to some.

While most of the debate questioned the transfer of the donor money to the private individual shareholders, no one has highlighted the fact that the initial donations helped create brand equity for the Compartamos name. This brand equity, along with other intangibles such as systems and procedures, was perhaps the basis of the success of the commercial for-profit agency. This success was then partially appropriated by private investors and those donors who got the shares, and not all the volunteers and employees in the same ratio.

When a person volunteers to work as an NGO for free or works for it at lower than market rate because he believes in the mission, the person is helping to create brand equity and other intangibles for the NGO. He does this knowing or trusting that the NGO is a not for profit and he therefore does not expect market payments.

This trust is belied when one of the people who manage the NGO decide to convert it to a for-profit. Even if he offers shares to all employees and volunteers, not all of them may have the

money to buy shares commensurate with the efforts they have put in. Thus, within the community of workers for the NGO, conversion to a for-profit redistributes the benefits from those who have a savings base and a risk-taking attitude to those who lack one of these two ingredients (either savings to invest or risk-taking).

Compartamos is of course not the only such case of governance questions. Conversion from NGO to Non-bank financial companies (NBFC) and from NBFC to banks seems to be the conventional wisdom. As the table below indicates, eight of the biggest ten MFIs in India are for-profit. Only two are not-for-profits. Of these eight, five converted from being a not-for-profit to a for-profit. These five include the top four.

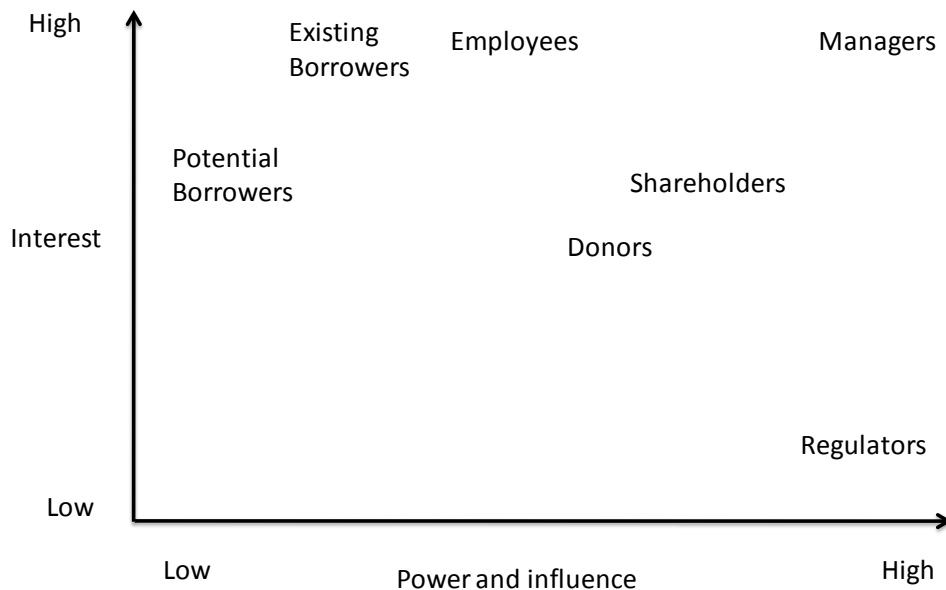
2008	Legal Status	Former status
SKS	NBFC since 2006	Society before
Spandana	NBFC since 2005	Society before
SHARE	NBFC since 2000	Society before
Bandhan	NBFC since 2007	Society before
Asmitha	NBFC since 2002	
SKDRDP	Trust	
BASIX	NBFC and Bank since 1997	
Grama Vidiyal	NBFC since 2008	Trust before
BISWA	Society since 1994	
Equitas	NBFC since 2007	

The point being made is that if an organization is a for-profit from the beginning or a not-for-profit from the beginning, this ethical question of governance and redistribution of profits being raised in this part of the paper does not arise. This question arises only for those organizations who convert from a not-for-profit to a for-profit.

This governance question is similar to an inverse question in the corporate social responsibility field. Should the managers of a for-profit company give donations to not-for-profits or should he give dividends to the shareholders and let them decide which non-for-profit cause to support

(Friedman, 1970)? This governance issue is also a critique (Ashta, 2009) of one of the two social business models proposed by Muhammad Yunus in his recent book (Yunus, 2007). It is the reason why Danone prefers that Grameen Danone provide some return and not a zero return, even if Danone has not invested directly into Grameen Danone but indirectly through a fund raised by its employees.

These issues indicate that governance issues are not just related to corporate forms and shareholder interests but have to be viewed in a larger stakeholder perspective (Ashta & Hudon, 2009). These stakeholders include shareholders, donors, managers, existing borrowers, potential borrowers, employees and regulators. A stakeholder analysis grid using interest (in the question of interest rates) on one axis and power and influence (on interest rates) on another axis indicates that managers are really interested in this question and have a high power and influence on interest rate levels. If these managers are shareholders, minority or majority, they can easily create situations to favour themselves to the detriment of others in the grid, especially those having low power and influence such as poor borrowers who are faced with a monopoly or oligopoly firm supplying funds to them.



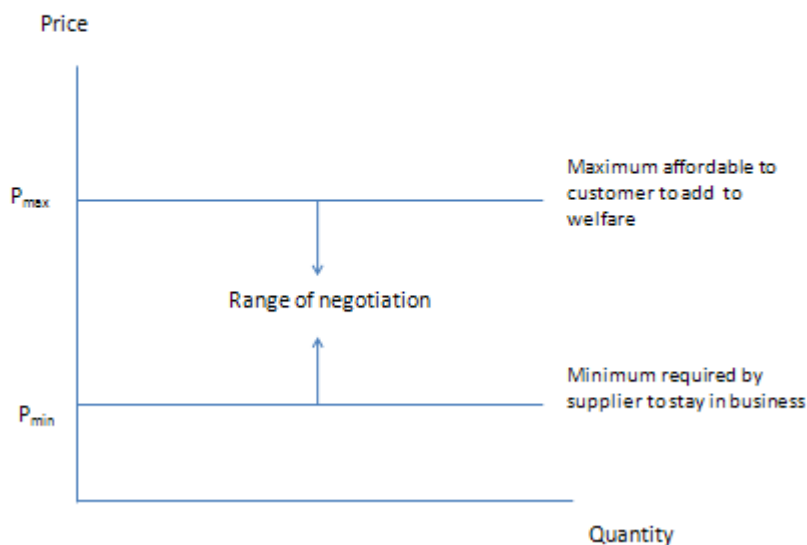
Source: Ashta & Hudon, 2009.

Thus, existing borrowers who are really interested in having low interest rates are easily sacrificed in a for-profit model by managers who are interested in high interest rates, to conserve profits to pay their high salaries or to receive dividends or capital appreciation if they happen to be shareholders also.

Hudon and Ashta (2009) weigh two considerations in a Rawlsian framework. On the one hand, interest rates should cover the costs of the MFI. Otherwise, the MFI would not be sustainable and would close down. Therefore a certain minimum of interest rates are required from poor

borrowers. In addition, a certain extra would be required for growth to serve future or potential borrowers. Perhaps, this minimum should also provide some fair return to shareholders. On the other hand, as shown in the figure on reservation prices, the highest interest rates are indicated by the opportunity cost of borrowing from moneylenders subject to a cap of expected profits from projects (i.e., whichever is lower). The question of ethics is how the interest should be shared along this spectrum. This sharing of the margin needs to be assessed by social performance rating firms.

Figure 3: Reservation prices



Thus, evaluating the social performance of a Microfinance Institution, even for interest rates, cannot really ignore the question of whether the firm is a for-profit or a not for profit and whether it has not been converted from one to the other. Nor can it ignore the fact that the MFI must be sustainable. This sustainability may itself be a function of whether it can get access to a donor funds which may again depend on whether it is an NGO or a for-profit. This aspect will also be developed in the recommendations section.

IV. The Transparency Question

The question of transparency has been brought back into public debate by the financial crisis. When millions of real estate buyers in the US could not pay their mortgages owing to ballooning clauses, the question raised is whether they knew the interest rates being paid (Krauss, 2007; Papini, 2008; Solnik, 2008). Thus the truth in lending laws question came back to the forefront.

As pointed out in Attuel-Mendes and Ashta (2009), lenders may often prefer to disclose flat rates because these are easy to explain and seem much lower than the real rates using declining balance methods. This problem becomes even more vicious in a microfinance setting because of the short term nature of the loans, bringing in questions of annualizing of the interest rate to make it comparable with alternatives. To take their example: you buy a good for 140 \$. You pay 20\$ cash and 150\$ to be repaid in 6 monthly instalments (for a total of 170\$). There are many different ways of representing the interest rate component of this transaction, reproduced in the following figure.

Example: you buy a good for 140 \$. You pay 20\$ cash and 150\$ to be repaid in 6 monthly instalments (for a total of 170\$)

Method	1	2	3	4	5	6
Calculation method	$(GP-RP) / RP$	$[(GP-RP)/RP] \times 2$	$[(GP-RP)/LA] \times \frac{2}{2}$	$[(GP-RP)/AOB] \times 2$	$(GP-RP)^2 - 1$	$IRR \times 12$ $IRR^{12}-1$
Interest rate	21.4%	42.8%	50%	86%	104%	81% (APR) 119%(EAR)

GP: global price
 RP: real price
 LA: loan amount
 AOB: average opening balance = $(LA+D)/2$
 D: downpayment
 APR: annual percentage rate of charge
 EAR: effective annual rate
 IRR: Internal rate of return

For finance professionals, last method is the whole truth: 119%

Source: Attuel-Mendes & Ashta, 2009

Thus, you could indicate that the interest rate is 21.4% and you would not be wrong because this is the flat component for six months. However, once you start getting in the question of how to look at the declining balance and how to compound for the annualization, the rates go up. If one uses simple annualizing by the APR, the interest rate is 81% and if one compounds, then effective annual rate (based on IRR) actually comes to 119%.

Of course, the interest rate component is only one aspect of the problem. Many other elements such as processing fees and compulsory charges, included in the above example, could be hidden and mentioned separately to disclose lower interest rates.

As an illustration of this problem of interest rate transparency, the websites of the top ten Indian MFIs provide the following information on interest rates.

	Interest Rate	Effective annual rate/ declining balance
	On flat basis	
SKS	12.5% to 15% flat	25.6 – 30.2%
Spandana	Not disclosed	
SHARE		23.6%
Bandhan	12.50% flat + 1% processing + 10% deposit	23.56% + +
Asmitha	12.50% - 15.00%	23.60% - 28.13%
SKDRDP		11% to 11.25%
BASIX		15%, 18%, 21% & 24% + a 10% cash deposit
Grama Vidiyal	Not disclosed	
BISWA		20%
Equitas		27.5% to 28.5%

Source: Websites visited on Oct 31, 2009

Two of the ten do not disclose the interest rates, at least on all the pages visited by the researcher.

Three of the remaining eight indicate both flat rates and annualized rates. Two indicate that there is a deposit associated with the interest rate and one of these that there is a processing fee also.

Poor illiterate borrowers probably do not visit these websites and the question remains as to what they understand on interest rates in their initial group meetings.

The next Recommendations section will develop this point further.

V. Recommendations for the interest rate component of social performance ratings

Based on the above discussion, we have seen that the levels of interest rates, the sharing within the range of possible interest rates and the transparency of interest rates are all elements to be included in the social performance rating of MFIs.

As Rosenberg et al (2009), point out, interest rates in different regions of the world are not really comparable. At the same time, high interest rates in one country affects the image of microfinance movement globally.

Therefore, we propose that one measure should be how an MFI's interest rates compare to the average in the country as well as the average globally. If the interest rate is higher than the average, the MFI gets a lower rating than the average. If interest rates are higher than the average, the MFI would get higher ratings than the average. To make it more objective, a simple measure based on standard deviation can be used as in Z values. How many standard deviations away from the country mean is the MFI's interest rates?

Example, an MFI is working in a country with an average interest rate of 20% and a standard deviation of interest rate of 5%. The MFI charges 30%, ie. 2 standard deviations above the average. If the rating company is using a five point scale, the MFI should get $2.5 - 2 = 0.5$ for this factor.

If world interest rates were 28% and world standard deviation of interest rates was 10%, the same MFI would get $2.5 - 0.2 = 2.3$ for this factor. MFIs in high interest rate countries would be penalized compared to MFIs in low interest rate countries for international comparisons, but this is only one of the factors in the social performance area.

A third factor would be to respect the social welfare function of the country. If the majority of the citizens of a country are perturbed by interest rates sufficiently to impose usury ceilings, then this factor should also be highlighted. MFIs operating at the usury ceiling, or those who camouflage part of their costs as fees to escape usury ceilings would be given a zero or low note. If the lowest interest rate MFI is given a 5, the other MFIs could be given a score based on their position along this spectrum. Example: in a country with a usury ceiling at 20%. The lowest rate any MFI is charging may be 10% and this MFI would get a 5. Then an MFI charging 12% would get a 4.²

A fourth consideration, perhaps in other countries, instead of using usury ceilings, a comparison could be made from the average money lender rate. The problem is that money lenders operate

² The calculation would be $5 \times [20 - 12] / (20 - 10)$

in informal markets and these rates are not known. However, consumer credit rates can be determined in most countries through surveys/ government statistical sources.

Bringing in the question of governance, three questions at least need to be raised.

One is whether the mission of the MFIs is for-profit or not.

The other two considerations concern for-profit MFIs. The first of these is whether a part of interest rate is going back to borrowers in terms of share capital and, ultimately, dividends or capital appreciation.

The second is whether profits are lower if there are more NGOs on the board of the MFI and if this brings down interest rates.

Finally, the question of transparency of interest rates should be included in the social performance criteria. While transparency on websites is part of the question, the actual transparency to the poor borrower is far more important. A first criterion is whether there is a written contract, even if the borrower cannot read it. A second criterion is whether the interest rate quoted in the contract is based on flat rates or declining balance rate. A third criterion is whether these are annualized or not. A fourth criterion could be whether processing fees and compulsory deposits are disclosed separately and excluded from the interest rate calculation or included in the interest rate disclosed.

VI. Future Research questions

The paper raises other questions, some of which go beyond the social performance measurement field but stem from the ethical questions.

A first question would be on how does one ethically optimise the determination of interest rates between the minimum for sustainability of the MFI and the maximum allowed by usury ceilings or moneylenders or project expected profitability.

A second question is whether volunteer workers in NGOs and donors actually feel betrayed when an NGO converts to a for-profit. The question needs to be addressed to former volunteers and former donors.

A third question is whether high interest rates stem from other services included in the MFI's offer. These include entrepreneurial advice or insurance charges. Would interest rates be reduced if these services were offered separately for a separate fee? Would people still take the insurance cover? Does packaging oblige them to take services they do not want?

As a last word, the reader is reminded that this paper concerns just one element in the social performance criteria. What exact weights should be given to interest rates in the whole set and, within this sub-set, what weights to the different elements discussed above is another question which will probably vary from rating agency to rating agency till some optimising criteria can be thought about.

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