PRICING TRANSPARENCY AND PERFORMANCE IN THE MICROFINANCE INDUSTRY: TRUTH-IN-LENDING, PROFITABILITY, SCALE, AND FUNDING

Nicolás Argüello et al.

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Pricing Transparency and Performance in the Microfinance Industry: Truth-in-Lending, Profitability, Scale, and Funding

Nicolás ARGÜELLO
Columbia School of International and Public Affairs, New York, U.S.A. nicolasarguello@gmail.com

Isabelle DELALEX
Columbia School of International and Public Affairs, New York, U.S.A. isabelle.delalex@gmail.com

Sun LIMVORASAK
Columbia School of International and Public Affairs, New York, U.S.A. revealsun@gmail.com

Victoria PETTIBONE
Columbia School of International and Public Affairs, New York, U.S.A. vpettibone@gmail.com

Shimeng SUN¹
Columbia School of International and Public Affairs, New York, U.S.A. ss3889@columbia.edu

Over the past few decades microfinance has advanced financial access for the world’s poor. In recent years, however, in the wake of the stunningly large IPOs of microfinance giants Compartamos and SKS and concurrent large-scale defaults in places like India and Nicaragua, popular discontent has emerged. A curtain has been drawn away to reveal just how little con-

1. We would like to thank Columbia University’s School of International and Public Affairs and the microfinance professionals who contributed to their time and expertise to the completion of the research.
sumer protection the microfinance industry has had, calling into question the effectiveness of microfinance in alleviating poverty. Politicians and policy makers have decried excessively high interest rates charged by certain microfinance institutions, in response, many countries have established interest rate caps. These efforts may be misguided as well as undermine microfinance’s original mission to financially empower the poor.

A central problem is that the interest rate presented to its customers often differs radically from the actual percentage rate (APR) an MFI charges, once the calculation method, timing, upfront fees and compulsory savings are accounted for. This misinformation prevents borrowers from making informed decisions, donors from identifying offenders, and the market from working efficiently. The difference is especially large for MFIs providing the smallest loans to the poorest and most rural clients, as they have the highest operating expenses and thus must charge the highest interest rates to remain viable. These MFIs are likely to mask their APR to avoid undue criticism. Government intervention that caps interest rates, rather than offering truth-in-lending regulations can encourage the MFIs to provide larger loans in denser areas, contributing to their retreat from their mission to serve the poor.

As opposed to placing blame solely on interest rates or advocating for interest rate regulation, pricing transparency – the alignment of what an MFI communicates as its interest rate to the borrower as compared to its actual interest rate – enables the client to make informed choices, creates competition in the market, and de-stigmatizes a high interest rate for those MFIs serving the extreme poor or those in rural, hard-to-reach areas. Information symmetry enables market forces to work more effectively, making interest rates more competitive and pressuring MFIs to streamline their operational costs as much as possible.

Many practitioners support transparent pricing in theory but find it difficult to practice for the aforementioned reasons. Furthermore, with no reporting or calculation standards, many institutions have found ways to increase their profit margins under the guise of a low interest rate and now fear transparency will diminish those margins. As Chuck Waterfield of MFTransparency explains, the problem is deeply entrenched:

“Once the industry began widely employing confusing product pricing, it became very difficult for MFIs to convert to transparent pricing. To do so, the MFI

2. As one example, many microfinance loans use a flat, rather than declining balance off of which interest is calculated. A loan quoted as 4% interest per month using flat method would have a 79% APR rather than 48%. For a full discussion of loan pricing in microfinance, see Waterfield, Chuck “Introduction to Transparent Pricing in Microfinance” accessible at: http://www.mftransparency.org/resources/introduction-transparent-pricing-microfinance/
would advertise what appeared to be the highest price in the market, even though their true price could actually be the lowest. As a result, the vast majority of MFIs practice non-transparent pricing even though many would prefer to do otherwise” (Waterfield, 2009).

Without understanding the upside of transparency, there is little incentive for institutions to adjust their behaviors. In fact, P.N. Vasudevan, Managing Director of Equitas Micro Finance India, insists that unless governments regulate and standardize MFI pricing, those institutions not practicing transparency will not change their policies. It is our intention that the findings of this paper might encourage those institutions to reconsider their pricing policies.

THEORETICAL FOUNDATION OF STUDY

Our review of the literature found there was no research establishing a direct and statistically significant positive correlation between pricing transparency and the actual profitability of a firm. In fact common sense suggests a negative relationship between the two i.e. if a firm can charge a higher interest rate under the guise of a lower, more attractive interest rate, it would presumably be able to increase its profit without losing clients. This line of thinking is what Truth-in-Lending legislation seeks to counteract (Zeisel, Boschan, 1968).

However, studies do support the hypothesis that transparency is beneficial to consumers as it enables them to make rational decisions (Durkin, Elliehausen, 1990; Hadfield, Howse, Trebilcock, 1998; Clemenz, 1979). There is also support for the theory that information disclosure is in the interest of certain sellers, as it enables consumers to differentiate between products and brands, allowing sellers with better products or services to benefit (Beales, Craswell, Salop, 1981). Markets are most competitive and most efficient when information is transparent to consumers and suppliers (Kroszner, 2007) and a lack of transparency can be costly both politically and economically, resulting in secrecy and corruption that can hinder investment and economic growth (Vishwanath, Kaufmann, 2001). However, for all the research that puts forth the benefits of transparency for the firm, there is likewise literature arguing that transparency limits firms’ profitability. Disclosure of financial information through regulatory compliance is costly (Cull, Asli, Morduch, 2011) and in a free market, full and voluntary disclosure is rare as companies may lose their competitive advantages (Vishwanath, Kaufmann, 2001).

In our review of the literature both within the field of microfinance and beyond, only one study, a recently published dissertation by Darlene...
Augustine, PhD (2012), supports the theory that MFIs with greater transparency perform better than those with less transparency. Using MFIs’ self-reported data drawn from the MIX Market, Augustine concludes that financial transparency, which she uses as a proxy for corporate governance, is positively correlated with better performance indicators due to a greater level of trust between the MFI and its customers. Our study investigates the relationship between financial transparency and performance further, looking not only at the customers, but at investors and donors and the overall industry. To that end, we combined the MIX data with data from Microfinance Transparency whose Transparency Index provides a scale with which to more accurately assess an MFI’s level of transparency as it relates to the pricing of financial products. Then we explored additional factors affecting an MFI’s long-term profitability including scale, and the impact of transparency on the firm’s ability to attract outside capital. Finally we inferred from the larger context of truth-in-lending legislation arising from the recent financial crisis in the US, the relevance of pricing transparency to the overall stability and resilience of the microfinance industry.

QUANTITATIVE ANALYSIS

Our quantitative analysis draws data from Microfinance Information Exchange (MIX), an online database including 15,000 MFI data submissions over 10 years, and MFTransparency, a not-for-profit organization established to promote the welfare of poor micro-entrepreneurs and to promote the integrity of microfinance as a poverty alleviation practice.

A weakness of much of the research in microfinance is that the majority of the data is self-reported and is thus prone to selection bias, which is hard to overcome since MFIs are rarely required to submit information on their loans’ pricing mechanisms to regulatory institutions or third party rating agencies. Notwithstanding, MIX is the most reliable and extensive source of microfinance data available, covering over 2,000 MFIs. MIX collects raw data from a form the MFI completes and when possible, from audited financial statements and internal financial statements. Financial data reporting is supplemented by questionnaires. MIX then calculates financial ratios such as Return on Assets (RoA) and Return on Equity (RoE). Though MIX also collects social performance data, currently only 12% of this self-reported data has been validated by a third party.3

3. Frequently Asked Questions: How Do I Know the Data Is Reliable, MIX Market, Internet, available here (as of May 1, 2012): http://www.mixmarket.org/about/faqs#datasets2
Although participation in the MIX Market is open to all MFIs, it is incumbent upon each MFI to decide whether or not to submit data. MFIs may choose to report some indicators and conceal others from year to year. Specific or individual MFI data are confidential and can only be used with the permission of the respective MFIs. MIX Market data are therefore not a random sample of all MFIs.

MFTransparency collects its data from actual loan contracts and repayment schedules provided directly from MFIs and rates their loan products using a “Transparency Index” – a higher score signifies a more transparent pricing mechanism. Submitted documents are verified by MFTransparency staff and then used as a basis for its annual percentage rate (APR) calculation. The results are posted on the MFTransparency’s website and available to the public. This open disclosure enables industry practitioners, journalists, donors, investors and regulators to flag data that appear suspect, based on their own knowledge and experience in the field, which helps ensure better accuracy of the reporting. Like with MIX, MFIs must elect to participate; however, as MFTransparency takes a comprehensive approach to specific countries, there is pressure for MFIs in those countries to participate, since not participating suggests the MFI is hiding something. MFTransparency is currently working within 17 countries, and is in the process of expanding its geographic focus.

In order to relate the transparency data – which is provided by MFTransparency – with financial indicators like RoA and RoE – which is provided by MIX – we merged the two datasets for MFIs reporting from both sources. This resulted in a dataset of 228 MFIs spanning the 17 countries covered by MFTransparency. MFTransparency collects data on a product-by-product basis, while MIX collects and presents data at the institutional level. To bring the datasets together, we aggregated the product-level MFTransparency data into institution-level indicators by taking an average, weighted by number of clients per product, for APR and transparency using up to the six largest products for each MFI. We weighted by number of clients per product to calculate averages that best represent the microfinance institution’s activities in terms of population being served. In order to blend the two datasets, we assigned MIX’s MFI ID to the corresponding MFI within MFTransparency, and pulled data from the corresponding year or the closest year possible. We also calculated an inflation-adjusted RoE and RoA using inflation statistics provided by the World Bank corresponding to the year the data was collected. For purposes of cross-country or regional analyses, we created a variable for average loan size divided by GNI per capita to normalize the data across countries. GNI per capita data was also obtained from The World Bank.
Because the data are not a random sample of MFIs within a country and because most countries have fewer than 30 data points available, we cannot test statistically whether our results reflect features of all MFIs. However an overview of descriptive statistics is included in the appendix.

We examine the data by country; however, when the sample size in a country is limited to fewer than five, we do not perform a country analysis (Mozambique, Rwanda, Uganda and Zambia). Occasionally we find that analysis in the aggregate (across all 17 countries) is meaningful for certain variables, knowing that such “global” analysis is subject to inaccuracies due to differences between countries and regions.

Our dataset is the basis for the Pricing Transparency Comparison Tool (See Annex B) we have developed in association with this research. The tool allows an MFI manager to do his own analysis of the data, filtering for criteria that best match his own institution. The user can generate graphs comparing transparency levels of the selected sample to multiple indicators such as APR, average loan size, RoA, RoE and number of clients. The tool also collects data from the MFI manager about his own institution, directing the user to calculate APRs and transparency levels per loan product using an additional tool on the MFTransparency website. Our program then aggregates the user’s product-level data into institution-level indicators so that it can be graphically compared to the other MFIs in the sample. The user’s MFI is represented on the graphs with a red bubble. In all graphs, bubble size represents a third indicator, which is selected by the user. Through this tool, the MFI manager can see for himself the relationship between transparency and the financial indicators he is most concerned with. Using the tool we anticipate he will observe that adopting greater pricing transparency policies may not negatively impact his MFI’s performance. The tool will be available and downloadable on Microfinance Transparency’s website (www.mftransparency.com) in 4Q 2012.

QUALITATIVE ANALYSIS

Our qualitative analysis centers around interviews with expert practitioners, particularly microfinance fund managers. Their insight into the importance and impact of pricing transparency creates one of the strongest business cases for pricing transparency, as they are contributing significant flow of funds towards MFIs. Our interviews covered three of the five largest multi-fund Microfinance Investment Vehicles (MIVs) and twelve other key players in the field of microfinance funding and operations. Their expertise greatly
contributes to the validity and significance of our study. A list of interviewees is attached in the appendix.

As noted above, the literature on pricing transparency is limited and there is no comprehensive study on its costs or benefits. Where possible, we have supplemented our findings with available analyses. The Consultative Group to Assist the Poor (CGAP), the UN, the Smart Campaign and other major actors in the microfinance field make valuable points about the impact and importance of increased client protection, we drew upon their findings in our analysis. To reduce variability in estimates, future research should include independently verified, larger sample data to solidify the research presented here.

RESEARCH QUESTIONS

The three key questions that MFI managers seek to answer in their cost/benefit analysis determining their compliance to transparent pricing policies are:

- Does transparency hurt profitability?
- Will the client base decrease if loan pricing becomes transparent?
- Will transparency improve or limit funding opportunities?

In order to help the MFI manager answer these questions within the limitations of our dataset, we frame our research questions as follows:

- What relationship exists between transparency and profitability in the MFI’s?
- What relationship exists between transparency and the MFI’s client base?
- How does pricing transparency impact the funding of MFIs?
- How does pricing transparency impact the sustainability of the industry?

TRANSPARENCY AND PROFITABILITY

In exploring the relationship between transparency and profitability, we first analyze the entire dataset to understand overall relationships between loan size, APR and transparency. Though we caution against an analysis of the dataset in the aggregate, some collective trends are insightful. Supported by research on the microfinance industry (Study on Interest Rates and Costs Document téléchargé depuis www.cairn.info -  -   - 123.176.42.2 - 04/03/2014 07h17. © De Boeck Supérieur
of Microfinance Institutions, SIDBI 2011), our assumption is that across regions, the MFI’s providing the smallest loans tend to charge the highest APRs and therefore have the lowest levels of transparency about their APRs. This assumption is confirmed in Figure 1: the Transparency Index appears to increase slightly as average loan balance divided by GNI per capita increases. That greater transparency exists with larger loans can be explained by a reduced pressure to mask interest rates for those MFIs serving the largest loans. Large loans have lower transactions costs (Cull, Demirguc-Kunt, Morduch, 2009). They tend to be provided in denser and more developed areas due to factors such as low transportation costs and loan officer’s access to a larger, geographically concentrated client base. Additionally, larger MFIs servicing larger loans are often subject to greater regulation which may have already lead to increased transparency.

*Figure 1 – Transparency and average loan balance/GNI across 17 countries*

When we explore this trend at the country level, we find a positive relationship between transparency and average loan size in India (Figure 2) and Colombia, and slightly positive in Bolivia and the Philippines. In Cambodia, Kenya and Malawi, transparency slightly decreases as average loan balance increases, and for the remaining countries, there is no noticeable
relationship between the two. These analyses caution against drawing too broad a conclusion about the aggregate.

Figure 2 – Transparency and average loan balance in India are positively related

We see a more pronounced trend of higher transparency scores with lower APRs across the full dataset (Figure 3). The fact that MFIs with the lowest APRs would be the most transparent is not surprising since those MFIs have nothing to lose by clearly disclosing their rates. Lower APRs are also generally seen in tandem with larger average loan sizes since, as mentioned earlier, larger loans tend to be cheaper to service.

Since the MFIs with higher transparency tend to have lower APRs, an incorrect but logical conclusion would be that they are also less profitable because they generate less income per loan. Our next analysis of MFIs financial performance measures opposes this conclusion.

We find no consistent relationship between transparency and traditional performance measures for financial institutions: return on equity (RoE) and return on assets (RoA) (nominal and real). Whereas our APR graph (Figure 3) clearly shows increased APR with lower transparency, no such equivalent patterns emerge for the profitability indicators, both in the aggregate and on a country-by-country basis. In the Philippines, for example, transparency increases as nominal RoE (Figure 4) and nominal RoA
increase; in other words the MFIs with the highest RoE and RoA tend to be more transparent. In Ecuador, however, transparency and RoE are unrelated, and in Columbia the relationship is only slightly positive. In India and Malawi, however, the relationship is negative: the MFIs with the greatest RoE and RoA tend to be less transparent. While these findings do not appear to help build a case that transparency is financially beneficial to MFIs, they do suggest that the reverse is not necessarily true: those institutions with the highest level of transparency do not consistently have the lowest returns. Our data suggests that being transparent is financially neutral. This finding is useful in building a case that MFIs should embrace transparency as it counters the concern that transparency will make the MFI become less profitable.

When we do an analysis of not-for-profit MFIs in the aggregate we find a somewhat higher RoA (nominal) for those not-for-profit MFIs with higher transparency ratings (Figure 5).

When we look at APR using bubble size as an indicator (Figure 5) and average loan size, we find that neither APR nor loan size consistently increase with RoA. In other words, neither increased price nor increased loan sizes are de facto related to greater RoA for the more transparent MFIs. This suggests that the driver for higher RoA in MFIs with higher transparency is lower costs rather than higher revenues. Perhaps not-for-profit MFIs with greater transparency are more efficient than those with lower transparency.
Transparency shows positive relationship with RoE in the Philippines.

Figure 4 – Transparency shows positive relationship with RoE in the Philippines

Transparency shows positive relationship to RoA (nominal) amongst not-for-profit MFIs in 17 countries (bubble size represents APR).

Figure 5 – Transparency shows positive relationship to RoA (nominal) amongst not-for-profit MFIs in 17 countries (bubble size represents APR).
We do not, however, see this trend with for-profit MFIs. In the aggregate, those with higher RoA tend to have slightly less transparent ratings (Figure 6).

Figure 6 – RoA (nominal) and Transparency amongst for-profit MFIs within 17 countries (Bubble size represents APR)

While analysis of RoE and RoA is inconclusive, when we look at the spread between Portfolio Yield and Operating Expenses/Assets, a very interesting trend occurs. We use this spread to capture MFIs returns above operating expenses, as a proxy for profitability. This indicator is important because those MFIs that are serving the poorest clients often have the highest operating expenses, as discussed earlier. If one only looks at profitability indicators that increase as operating expenses decrease, the analysis may disregard some of the MFIs that are remaining true to their social missions and therefore have higher operating expenses. Looking at the relationship between transparency and spread, we find that in eight out of 13 countries with more than five MFIs per sample, the two are positively related, as is

4. Portfolio yield is defined as interest income and fees on loan portfolio divided by the average gross loan portfolio.
5. Spread is defined as (Portfolio Yield minus Operating Expenses)/Assets.
seen below for Bolivia (Figure 7). This holds true for Bosnia, Cambodia, Columbia, Ecuador, Ethiopia, Kenya and the Philippines.

For these countries, the MFIs with higher transparency ratings show greater profit. It is unclear what is driving this greater profitability. For some of the countries, such as Bolivia and Ecuador, we see lower operating expenses for those MFIs that are more transparent, which could explain the greater profit (Figure 8). For others, however, such as the Philippines and Kenya, we see higher operating expenses for those MFIs with greater transparency, but also higher yields. Regardless of the underlying causes, the important inference is that, based on this dataset, more MFIs than not have found a way to secure higher profits than their competitors while being more transparent in their pricing.

While the positive relationships between financial indicators (e.g. spread and RoA) and transparency are encouraging, we recognize that our analysis is limited and these relationships might not be causal. They are, however, promising findings that further research will clarify. To substantiate these findings, we complement our quantitative data with interviews and research to evaluate how transparency impacts clients, investors and the microfinance industry as a whole.
TRANSPARENCY AND SCALE

To examine the interaction of transparency and scale, we begin by looking at the relationship between MFIs’ transparency score and their number of clients. As shown in Figure 9, there is a slight positive relationship between these two variables over the entire dataset; however, among MFIs with fewer than 100,000 clients, the relationship is neutral. This finding suggests that greater transparency is not, contrary to common concerns among MFI managers, necessarily connected to a decreased client base. While our dataset likewise does not show greater transparency connected to greater scale, our qualitative research does suggest that greater transparency contributes to good performance evaluations, gains in market share and positioning and ultimately leads to better client retention over time. Inversely, bad performance can lead to a loss of market share and exclusion from the market.

From a simply practical viewpoint, the more transparent a loan is, the more easily a customer can make an informed choice that best serves his or her needs and interests, be satisfied with the terms, and properly plan for repayment. Oikocredit’s Deputy Director of Loans and Investments, Guillermo Salcedo, summarizes, “In theoretical terms, your business depends on your client base. If you provide good products with transparent pricing, it is beneficial in terms of strengthening your client base. There’s nothing worse than an

Figure 8 – Lower operating expenses for MFIs with greater transparency in Bolivia
unhappy customer, especially in microfinance.” Xavier Pierluca, Chief Investment Officer of Bamboo Finance (previously Chief Investment Officer of BlueOrchard when interviewed), sees a correlation between transparency and the long-term health of a microfinance institution’s staff, client base and subsequently its overall health: “If you look at Banco FIE in Bolivia, for example, it’s been disclosing all its information to clients from day one. It has been able to develop a relationship of trust and mutual respect that goes a long way. Clients that can be financially illiterate will eventually learn and find out that they have been fooled.” Pierluca also explains the effect that poor social performance has on an MFI’s staff: “Many organizations have closed their doors because of a huge turnaround of loan officers who don’t want to work with an organization that is fooling a population in need.” Maintaining current clients, attracting new clients and keeping a dedicated staff are all related to how clearly an MFI chooses to communicate with the population it is serving.

The investors’ comments highlight the importance of building fair, long-term relationships rather than squeezing out extra dollars from customers in the short-term. The lack of pricing transparency also prevents price competition which, contrary to what an MFI might expect, can actually hinder their ability to attract clients. Research supports this point – as David Cracknell

6. As of April 2012, Blue Orchard Investments, the private equity division of Blue Orchard, is operating as Bamboo Finance.
and Hermann Messan argue, “the obfuscation of prices/fees means that the competitive environment is not working for the clients on price in the same way as it is in other aspects of the product” and that this state of affairs “presents an important challenge to the microfinance industry and an opportunity for the MFIs to differentiate themselves on the basis of transparent and fair pricing.” (Cracknell, Messan, 2006) In a competitive market, an MFI can distinguish itself by how it prices its products and how it communicates its prices. It has the ability to add services and make appropriate adjustments to the pricing that a customer can understand and value. Lacking transparency, an MFI is hard pressed to differentiate itself from others. Vidar Jorgensen, president of Grameen America and Grameen Research, confirms this point, saying, “It’s not necessarily that pricing transparency would hurt MFIs’ profitability. With transparency, it’s very competitive. MFIs could have long-term sustainability.” Jorgensen adds that without transparent pricing, MFIs might be profitable in the short term but, echoing earlier comments, they will eventually be “subject to some kind of backlash when their clients find out the truth.”

Women’s World Banking, a network of microfinance organizations with a strong focus on female empowerment, has been encouraging its members to sign the MFTransparency Endorsement Statement. WWB representatives highlighted the added importance of pricing transparency and pricing education to its constituents, as literacy levels in the developing world among poor women are generally lower than men, and for many women it is culturally unacceptable to ask questions, making it even harder for them to understand the terms of a loan.

Financial illiteracy is an important issue regarding pricing transparency not only for poor women, but also for the entire client population. This means that simply stating a true APR is not a sufficient condition for an MFI to achieve true pricing transparency. A number of studies, especially on the subject of mortgage pricing in relation to the Truth-in-Lending Act, have confirmed that many customers find APR confusing (Lee and Hogarth, 1999). Practitioners within the microfinance industry caution that the focus on pricing transparency must be combined with clear and simple communication. Ellen Willems, Portfolio Analyst at the Emerging Markets department of Triodos Investment Management, describes the difficulty. “When I communicate about APR or EIR, it is challenging since many people don’t really know what it’s about.” Caroline Norton Vance, who works in Deutsche Bank’s Global Social Investment Funds, holds a similar opinion, saying, “transparency is not a clear-cut case...” and that publicly posting the details of interest rates and other terms is not enough. MFIs have the responsibility to ensure that pricing terms are understandable to all clients. These sentiments are echoed by MFTransparency, The Smart Campaign, the Principles for
Investors in Inclusive Finance and other movements for the implementation of pricing transparency. For clients to benefit from pricing transparency they must understand all the loan terms.

**TRANSPARENCY AND INVESTORS**

The microfinance industry was hit hard by the late-2000’s global financial crisis, causing increased default rates and decreased demand for funding. Yet, this period also witnessed the rise of microfinance as a commercial market with potentially high returns for outside investors. The notion that microfinance was (very) profitable was further confirmed by multi-million-dollar IPOs in the microfinance sector and a global tendency for MFIs to shift from nonprofit to for-profit status. This new state of affairs was also accompanied by intensely critical media coverage. Prominent examples of this include suicides over debt, Nicaragua’s “No Pay” movement (a public backlash against over-indebtedness and high interest rates charged by MFIs), and the recent microfinance troubles that led to government involvement in India. Events such as these have heightened public distrust of microfinance and its social objectives.

However, these events have been beneficial in that they have heightened investor concerns regarding reputation risk and have indeed served to encourage microfinance funds to strengthen their social performance indicators and standards (MicroRate, 2011). Microfinance funds and MIVs are rapidly shifting their focus away from profit maximization and onto increased social performance with moderate returns.

This policy shift should have a profound influence on the practices of MFIs worldwide because microfinance assets are increasingly being managed by impact investment funds and MIVs. MicroRate, a leading social rater that focuses on evaluating MIVs, shows that as of 2010, MIV assets totaled over $6.4 billion—representing a large portion of the worldwide microfinance industry. Microfinance assets are also becoming increasingly concentrated into fewer funds as large MIVs are growing at faster rates than small and medium-sized MIVs (MicroRate, 2009). The largest five microfinance asset managers held over half of global microfinance assets held by MIVs in 2010.

In past years, it was sufficient for many MIVs and fund managers that MFIs disclose their financial reports in order to be considered “transparent.” Today, social metrics regarding transparency may require that MFIs publicly display an annualized percentage rate (e.g. APR in the US or EIR in the Europe) and take the extra step to explain interest rates to clients. In fact, the largest five multi-fund MIV managers in 2010 – BlueOrchard,
responsAbility, DWM, Triodos, and ACCION – all require certain standards of social performance and pricing transparency as part of their investment process. Because these five organizations represent over half of all microfinance assets held by MIVs, (MicroRate, 2011) they have a strong influence on the microfinance industry worldwide. If an MFI scores poorly on social performance, it will most likely not be eligible for investment. Indeed, many interview respondents at large MIVs stated that if an MFI does not have social objectives, it is automatically disqualified for funding. As Guillermo Salcedo from Oikocredit said, “We would never fund an organization that is purely commercial. If there’s no social value, we wouldn’t fund it.” Our interviewees all echoed this point and agreed that pricing transparency contributes positively to an MFI’s long-term performance.

Many MIVs have in recent years created their own scorecards that evaluate social performance metrics. A number of these scorecards base their social performance measurements on the Smart Campaign’s Client Protection Principles (CPPs). One of the seven principals focuses on pricing transparency (The Smart Campaign, 2011), implying that even if pricing transparency is not evaluated independently, it is a component of the overall social performance assessment. Some MIVs have a minimum score below which an MFI will simply not receive an investment. As an example, the scorecard of Oikocredit has five dimensions. The second dimension, client welfare and benefit/protection, has a weight of 40 percent. One of the questions
concerns pricing transparency, asking whether or not the MFI discloses all loan information to its clients as well as ensures that they understand the terms of the loan, taking into consideration the client’s literacy.

Similarly, the social performance scorecard of Deutsche Bank’s Global Social Investment Fund assigns a weight of 20 percent of the total score to the CPPs. In BlueOrchard’s scorecard, CPPs account for 30 percent of the total score. Triodos Bank, Triple Jump and other large microfinance funds also include the CPPs in their internal social scorecards. Other MIVs and fund managers, such as responsAbility and key industry players such as Women’s World Banking, do not have specific criteria regarding pricing transparency, but general standards for what they consider to be responsible. In these cases, pricing transparency is determined qualitatively. In their assessments, they ask MFIs questions regarding pricing transparency to determine if customers are treated with dignity and respect. Every year Women’s World Banking gives the “Excellence Leadership Award” to MFIs that fare well on assessments. However, because the award is based on self-reported information from its members, it is not an entirely objective evaluation.

In order to make evaluations more objective, some MIVs and fund managers perform random site visits and create due diligence reports, conducting interviews and surveys in terms of pricing transparency and other social performance indicators. The quantified social performance scores, along with analyses of financial performance, risk assessments, and other pieces of information, together determine the final investment decision.

Though the majority of investors perceive pricing transparency as significant for MFIs, there are many other social metrics that they consider. As Head of Debt Investment at responsAbility, Martin Heimes said, “Pricing transparency is only one element of judging MFIs. It’s a necessary condition, but not sufficient. If an MFI does not have transparency, it reflects very badly on its overall quality”. According to Bamboo’s Chief Investment Officer, Xavier Pierluca, “Transparency is one of the social metrics we look at it before we invest. If price transparency is not measurable, once we invest, we encourage MFIs to offer loan products that are compliant with truth-in-lending principles… It is worth noting that price transparency is one of many truth-in-lending principles.” When making investment decisions, many fund managers use their social performance assessments as a guide, rather than having strict cut-off ratings, though for some funds, strong social performance can actually increase the acceptable financial risk profile of the investments. Luca Paonessa, Senior Advisor for Portfolio Allocation and Risk at Triple Jump, explains that some of their investment mandates accept taking on significant additional financial risk if the social performance is considered high, so when making an investment...
decision, the question of whether financial or social performance has more weight “accords with different types of mandates the investors have.” Without question, Oikocredit is first and foremost socially driven. “Social performance management is one of our key selling points to our investors, who are fundamentally socially motivated; that’s the kind of investors we have,” says Guillermo Salcedo, Deputy Director of Loans and Investments of Oikocredit. Funds such as Deutsche Bank’s Global Social Investment Funds and Triodos Microfinance Fund are also socially-driven. They focus on how to benefit and empower disadvantaged groups in remote areas and do not promise investors high financial returns. In fact, many such funds tell their investors from the outset that they will not provide high returns. However, as interviews with senior officials at responsAbility, Triodos Bank and Oikocredit suggested, MFIs need to be financially viable and sustainably generate moderate returns, in addition to having high social performance.

On a global level a consortium of investors along with government agencies are working to establish better consumer protection standards for the microfinance industry. The Principles for Investors in Inclusive Finance (PIIF), an offshoot of Principles for Responsible Investment, is one such initiative launched in January 2011 and developed by a group of investors interested in financial inclusion,7 her royal highness Princess Máxima of the Netherlands, the UN Secretary-General’s Special Advocate for Inclusive Finance for Development, and the World Bank’s Consultative Group to Assist the Poor (CGAP). PIIF lists transparency as the fifth principle and calls for signatories to endorse MFTransparency and embrace other tenets of transparency beyond pricing. With signatories ranging from socially driven fund managers such as BlueOrchard and responsAbility Social Investments to large asset owners such as General Board of Pension, Health Benefits United Methodist Church and Nedlloyd Pension Fund, PIIF is indirectly impacting a huge number of microfinance organizations globally. PIIF signatories will take part in an annual reporting process beginning summer of 2012 that questions their understanding of what is happening at the MFI level. One question in particular is how the investor knows that the MFI’s pricing is in line with what the MFI claims it to be. Investors will be asked to provide examples. The purpose of these questions is not only to obtain satisfactory answers but to prompt investors to ask these questions of their investees, recognize where information is lacking and take appropriate action. The questions aim to have a trickle-down effect, ultimately causing policy and corporate governance on the MFI level to be more inclusive, transparent and

7. Financial inclusion is defined by the Principals of Financial Inclusion as, “the expanded access to affordable and responsible financial products and services to those traditionally excluded.”
responsible. Nevertheless, despite the increased demand for socially-driven microfinance investments, there are still many commercially-minded investors that invest in MFIs that score poorly on social performance so long as they have very attractive returns. Regarding such investments, Piercula from Bamboo Finance is skeptical. “They have high profitability in the short run,” he said, “but we feel that because they are not dealing with the clients in the right way, and that they are fooling their clients, we believe that in the long run they will not be financially viable.” Moreover, among the many interviews conducted, no fund manager believed that pressure from investors to meet certain financial returns had changed or dampened the recent focus on social performance indicators like pricing transparency.

In short, as the initiatives toward ensuring greater social returns influence the industry, and as microfinance becomes recognized as an asset class in global financial markets, MFIs will increasingly have to compete for funding based on their ability to meet social metrics such as pricing transparency. Just as overall financial transparency increases institutions’ access to funding (Hope, Thomas, Vyas 2009), pricing transparency is playing an increasing role in the funding equation. In order to ensure their ability to remain competitive in the long run, it is therefore in a microfinance institution’s best interest to implement transparent pricing.

TRANSPARENCY AND THE MICROFINANCE INDUSTRY

A stable industry is in the best interest of each MFI. While robust, long-term studies on the impact of transparency on microfinance as an industry do not yet exist, we can infer the importance of transparency to the financial health of the industry by looking at other lending-based industries. The example that immediately puts itself forth is that of the sub-prime mortgage crisis in the United States. While arguments vary on the degree of blame to place on the many factors leading to the crisis, concerns about evidence of consumers’ abuse facilitated by the lack of consumer protection in the form of transparency led congress to propose the creation of the Consumer Financial Protection Agency. President of the Center for Responsible Lending, Mike Calhoun, in written testimony to the Senate Banking Committee states that, leading up to the crisis, regulators, “tasked with evaluating both safety and soundness and consumer protection concerns – largely focused on short-term profitability, giving short shrift to consumer protection. Unfortunately, the lesson was not learned that protecting consumers and bolstering the safety and soundness of financial institutions go hand-in-hand in the long term.” (Calhoun, 2011)
Consumer Financial Protection Bureau, which his testimony advocates a continued need for, was established to reinforce consumer protection in the wake of the crisis. The CFPB July 2011 Progress Report explains, “A fair, efficient, and transparent market depends upon consumers’ ability to compare the costs, benefits, and risks of different products effectively and to use that information to choose the product that is best for them... The principal role of consumer protection regulation in credit markets is to make it easy for consumers to see what they are getting and to compare one product with another, so that markets can function effectively” (Consumer Financial Protection Bureau, 2011). The CFPB, Mike Calhoun and others echoed the notion that market efficiency exists when simplified effective disclosure enhance consumers’ understanding. Accurate information is critical to be more competitive, and thus create more efficient markets and effective disclosure also has the capacity to weed out abuses (Krozer, 2007).

Asymmetric information, especially regarding pricing, stifles competition and contributes to the stagnation of the entire industry (or worse). The report’s emphasis on the importance of easy-to-understand communication echoes the findings of Lee and Hogarth (1999) and Thakor, Beltz and Barefoot (1993) on the frequency of misunderstanding due to complexity and information overload. These studies highlight the importance of marrying transparent pricing policy to comprehensive communication of terms.

For an individual MFI in a region with low transparency, the concept of making a transition towards transparency is a scary one. As Ging Ledesma, Director of Social Performance and financial analysis at Oikocredit cautioned, “For transparency to work, everyone else has to be transparent. If not, you put yourself at a real disadvantage. If you’re the first one to go, it’s painful.” As competition for funding and clients increase, and investors and clients place more emphasis on consumer protection, however, it will be in the best interest of those MFIs to be the first to embrace pricing transparency, and many will find themselves ahead of the competition when the tide changes in their region. Gil Lacson and Rebecca Ruf from Women’s World Banking believe that the historical trend towards extreme MFI commercialization will likely be reversed. They assert that “sometimes there’s a swing, and there is a pushback in India towards being more aware of social mission and focus.” Along with a possible shift towards social mission, Lacson and Ruf highlight the value of industry-wide competition that pricing transparency facilitates, noting that it “helps to understand your competitor and microfinance landscape better. Knowing pricing transparency is taking out one variable that is unknown in the competition.” Xavier Pierluca, Bamboo Chief Investment Officer, sums up the historical importance of transparency: “The commercial microfinance sector is about 25 years old. The organizations that have tried to grow and have not
practiced transparency have failed.” His point is reiterated by Nadine Chehade from Planet Rating who concludes, “History has proven that transparency is better for MFIs in the long run.”

RECOMMENDATIONS AND CONCLUSION

In 2010, when the District authorities in Andhra Pradesh closed down 50 branches of major finance institutions following allegations of usurious interest rates, the reputational cost to the microfinance sector had an impact on the funding of MFIs well beyond India. The subsequent social and economic cost of drying credit lines to the poor was very material. The governments’ response was swift, and a number of countries are working to curtail egregious interest rates by creating an interest rate cap. In May 2011, the Reserve Bank of India established the cap at 26% on loans less than 50,000 rupees ($1,124) and the Bangladeshi government’s Microcredit Regulatory Authority (MRA) set an interest rate cap of 27% on microloans effective July 2011. As this paper has argued, the problem with interest rate caps is that they hurt the poorest clients by making it unprofitable for a microfinance institution to continue providing the small and short-term loans (Reed, 2010). As legitimate microfinance institutions become unable to serve the poorest markets, microfinance clients are more vulnerable to predatory lending practices.

However, pricing caps have benefited some MFIs already practicing transparency whose interest rates were already below the cap. P. N. Vasudevan, Managing Director of Equitas Micro Finance India said that since India has passed the interest cap legislation, many MFIs who were taking advantage of the poor are now losing money because they lack the organizational efficiency that would allow them to operate profitably with lower interest rates. He credits fair and transparent pricing for contributing to put his organization on a sustainable path before the legislation passed. His company now has the competitive advantage. While he cautioned against using the threat of punitive legislation as incentivize to compliance to practicing transparency, MFIs should understand that they may shortly find themselves at a disadvantage if they are not more transparent.

An alternative policy to curtail interest rates would be limiting an MFI’s return on equity (RoE) to a set percentage based on its mission and location. But legislating acceptable levels of RoEs is also problematic. MFIs’ sustainability hinges on their ability to strike a balance between their development goals and business interest. It is a challenge for MFIs to be able to provide services at cost on par with the formal banking system.
Ignoring that MFIs’ profits are contributing to a institutions’ attractiveness to investors may be misguided. Based on the DuPont Equation: \( \text{ROE} = (\text{Profit margin}) \times (\text{Asset turnover}) \times (\text{Equity multiplier}) \), an MFI mandated to limited profit margin, would need to increase its asset turnover and, or, increase its equity multiplier to maintain a sustainable level of ROE; which may not be reconcilable with the MFI social mission to provide financial access to the poor. If an MFI has an asset turnover ratio of 1.5 serving poor clients, the company generates $1.5 of revenue for every $1 of assets (loans). If the imperative to increase revenue per loans to the poor has a fixed cap imposed by government policies, MFIs are incentivized to shift their product offering to more affluent debtors to remain profitable. With lower ROE, MFIs could choose to increase their equity multiplier, but this approach has a downside since it is achieved through higher leverage.

To prevent higher interest rates, government and multilateral organizations have also relied on funding subsided interest rates of not-for-profit MFIs serving small loans of poor clients. As Jessica Haeussler suggests, “subsidized interest rates distort markets and can foster a culture of rent-seeking and weak repayment ... there is widespread consensus that subsidies on interest rates are an inappropriate use of government and donor funds” (Haeussler, 2009).

A number of non-governmental organizations are working with microfinance institutions to promote good governance and compulsory prudential regulations, ideally making the above regulatory frameworks unnecessary. MFTransparency is at the forefront of efforts to increase pricing transparency throughout the industry. Along with independently collecting, analyzing and presenting financial data from institutions within 17 countries to date, the organization works towards transparency by collecting signatures from MFIs to endorse its mission.\(^8\) Several organizations and initiatives also promote pricing transparency in the microfinance sector as one element of their broader social agendas. The Social Performance Task Force, a globally-supported industry initiative based in the US, and the Smart Campaign (an initiative of Center for Financial Inclusion and Consultative Group to Assist the Poor) are both limiting asymmetric information on rate pricing by creating universal standards for social performance management which include pricing transparency as one of the main criteria. Organizations like the UN have developed Principals for Responsible Pricing and a group of investors have become signatories of the Principals for Investors in Inclusive

\[^8\] As stated on their website, the MFTransparency mission is to “facilitate the collection and dissemination of transparent microcredit product pricing information and, educate stakeholders and enhance their understanding of microcredit product pricing.”
Finance, both of which advocate for pricing transparency among other best practices. None of the initiatives advocate that MFIs should only present their interest rates in terms of APR or EIR; however, these annualized, comprehensive calculations provide uniform, objective measures that, along with other methods of price communication, enable clients to compare one loan product or provider with another.

The results of this study compliment the work of these organizations and initiatives, suggesting that it is possible for an MFI to be profitable, achieve scale and continue to serve the most poor while practicing pricing transparency. While the research does not inform an MFI how to be transparent and profitable, it does present evidence that there are many MFIs who have discovered how to achieve their double bottom line of social impact and profit.

The Pricing Transparency Comparison Tool developed for MFTransparency allows MFIs to compare their loan pricing to their peer groups. The value proposition of this interactive tool is to enable practitioners, donors and investors, to quickly assess the level of transparency of MFIs by region, loan size and applicable truth-in-lending legislation. The tool’s visualization of price transparency’s peer performance incentivizes MFIs to align their practices with those of the best performers. The tool also decreases the stigma on institutions providing the smallest loans whose APRs is higher than others, as these institutions’ APRs reveal themselves to be normal when compared to their peers.

The data analyzed in this paper outlines that there is value in pricing transparency. Though causality between transparency and profitability could not be established, our data suggest that transparency in pricing relative to profitability is either neutral or positive; that donors and investors put a premium of MFIs with transparent pricing policies and that clients are better served by MFIs practicing full disclosure of the loan pricing. These findings should encourage microfinance institutions to communicate their rate pricing with transparency and consistency and policy makers to support greater truth-in-lending disclosure requirements.

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### APPENDIX

**ANNEX A. DESCRIPTIVE STATISTICS FOR KEY INDICATORS ANALYZED WITHIN THIS PAPER.**

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of MFIs</th>
<th>Transparency Index</th>
<th>Average Loan Balance</th>
<th>Annual Percentage Rate</th>
<th>ROA</th>
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<td>8</td>
<td>Max: 61.0%</td>
<td>Min: 83.7%</td>
<td>Mean: 71.2%</td>
<td>74.8%</td>
</tr>
<tr>
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<td>98.9%</td>
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<td>69.3%</td>
</tr>
<tr>
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<td>91.6%</td>
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<td>82.7%</td>
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<td>99.9%</td>
<td>85.6%</td>
<td>88.1%</td>
</tr>
<tr>
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<td>72.8%</td>
<td>72.4%</td>
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<td>Kenya</td>
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<td>132.6%</td>
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</tr>
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<td>103.7%</td>
<td>64.6%</td>
<td>45.4%</td>
</tr>
<tr>
<td>Mozambique</td>
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<td>74.7%</td>
<td>71.3%</td>
</tr>
<tr>
<td>Philippines</td>
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<td>39.4%</td>
<td>135.9%</td>
<td>73.8%</td>
<td>63.6%</td>
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<tr>
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<td>62.8%</td>
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<td>Tanzania</td>
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<td>54.3%</td>
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<td>89.4%</td>
<td>83.8%</td>
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<td>7</td>
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<td>65.3%</td>
<td>55.7%</td>
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<tr>
<td>Country</td>
<td>ROE</td>
<td>Yield</td>
<td>Spread</td>
<td>Profit Margin</td>
<td>Operating Expenses/Assets</td>
</tr>
<tr>
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<td>--------------</td>
<td>-------------</td>
<td>------------</td>
<td>---------------</td>
<td>---------------------------</td>
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<tr>
<td>Azerbajan</td>
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<td>22.3%</td>
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<td>-10.8%</td>
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<tr>
<td>Cambodia</td>
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<tr>
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<td>10.8%</td>
<td>22.2%</td>
<td>25.5%</td>
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<tr>
<td>Ghana</td>
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<tr>
<td>India</td>
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<td>73.9%</td>
<td>62.7%</td>
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<td>4.8%</td>
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<tr>
<td>Zambia</td>
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<td>14.9%</td>
<td>22.8%</td>
<td>77.0%</td>
</tr>
</tbody>
</table>
ANNEX B. LIST OF EXPERTS INTERVIEWED AND AFFILIATIONS

Nadine Chehade, Business Development Manager at Planet Rating

Ximena Escobar de Nogales, Head of Social Performance at BlueOrchard Investments Management

Emilie Goodall, Project Manager of Principles for Investors in Inclusive Finance at UNPRI Principles for Responsible Investment

Martin Heimes, Head Debt Investments at responsAbility Social Investments AG

Vidar Jorgensen, President of Grameen America and Grameen Research

Gil Lacson, Network Engagement Manager at Women’s World Banking

Ging Ledesma, Director of Social Performance and financial analysis at Oikocredit

Barbara Magnoni, President of EA Consultants

Luca Paonessa, Senior Advisor of Portfolio Allocation and Risk at Triple Jump

Xavier Pierluca, Chief Investment Officer at Bamboo Financial Services

Rebecca Ruf, Network Engagement Manager at Women’s World Banking

Guillermo Salcedo, Deputy Director of Loans and Investments, Oikocredit

Caroline Norton Vance, Assistant Vice President, Global Social Investment Funds Group at Deutsche Bank

P. N. Vasudevan, Managing Director at Equitas Micro Finance India Private Ltd.

Ellen Willems, Portfolio Analyst at Triodos Investment Management
### Pricing Transparency Comparison Tool

**Part 1**

Choose your country: Argentina

Compare yourself to your peer group using the following filters:

- **Comparison region**: All
- **Institution Type**: All
- **Scale (number of clients)**: All
- **Truth-in-lending legislation in effect**: All
- **Restrict comparable data to your year**: All
- **Size of your comparison sample**: 238

**How to use this tool**

Complete Part 1 to generate graphs of your selected peer group. If sample size becomes too small, consider using fewer filter restrictions.

To compare your MFI to the sample selected, complete Part 2 (optional). Part 2 aggregates your product-level data to an institutional level and situates your MFI in relation to others with a red dot on the graphs.

**Part 2 (Optional)**

Your MFI inputs:

To complete the following table, use the MFI Transparency Tool to calculate APR and Transparency Index for each of your Loan Products. (Click here)

<table>
<thead>
<tr>
<th>Product</th>
<th>Number of clients</th>
<th>Average loan balance (US$)</th>
<th>APR (%)</th>
<th>Transparency Index (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product 1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product 2</td>
<td></td>
<td></td>
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<td>Product 3</td>
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<tr>
<td>Product 5</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Product 6*</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Aggregate values**

- **MFI size**: 
- **MFI size of GNI/capita**: 

*If your MFI has more than six products, use this column to aggregate the remainder of your products.