WHAT'S IN A MICROFINANCE INTEREST RATE?

Ensuring transparency and fairness in financial inclusion

MicroVest's belief in the power of responsible finance to serve unbanked and underbanked populations is evident in our portfolio, made up primarily[1] of investments in microfinance (MFI) and small and medium enterprise (SME) lending institutions in emerging and frontier markets.

The success of this approach is only possible, however, if responsible financial institutions operate in a manner that serves and protects customers. This isn't solely about morals – transparency and fairness are the hallmarks of any strong financial institution. What's good for borrowers is just as good for investors.

This ideal is captured in our due diligence process, which examines – among many other things – how MFI and SME lenders calculate the rates for their loanmaking. By putting our investments to work in those institutions that offer fair and competitive rates, we are strengthening the financial impact of our capital, promoting transparency and helping to diminish the footprint of problematic lenders.

HOW RATES ARE DEVELOPED

Interest rates among responsible financial institutions will vary across loan structures and countries. Among the institutions in our portfolio, we typically see average interest rates of 25% across microfinance and SME loans.

These rates represent a significant reduction from the 300% or higher rates that predatory lenders have historically charged underserved businesses. Today's rates are the product of three key factors:

1 THE OPERATIONAL COSTS ASSOCIATED WITH UNDERWRITING

Underwriting loans in a responsible and diligent manner is a detailed, high-touch process. In many markets, loan officers will go directly to the client to underwrite the loan, which often means traveling long distances across poor infrastructure. An extensive branch network is also needed to reach clients in underdeveloped areas, which requires additional overhead costs, typically 4-5x higher than the average Western retail community bank.

2 THE COSTS OF FINANCING IN EMERGING MARKETS

The average cost of funding for a microfinance loan is about 9%,[2] the bulk of which is driven by a government's benchmark rates. In Peru, for example, the yield on a 5-year government treasury note was about 5.5 % at the end of January 2019. No financial institution would be able to borrow money at a rate lower than that benchmark and typically you would expect a 2-5% risk premium be added to the rate at which the government can borrow.

3 THE RISK PROFILE OF THE BORROWER

Though losses at the responsible financial institutions we invest in are less than Western consumer debt, credit card, and commercial loan portfolios, the risk of loss adds to the cost of any financial institution. The institutions in our portfolio have average write-off rates of around 1%,[3] though it varies by country and institution. These low default rates are the result of years of building customer insights and putting the right governance, controls, oversight and incentives in place to responsibly underwrite this prodigious market.

1. Over 90% of MicroVest's portfolio is split evenly between MFIs and SME lending institutions. The remaining portion is in fintech, education and housing financing institutions that support financial inclusion.

2. Source: Symbiotics Banking for Impact, 2018.

3. Historical data for the average write-off rate at our portfolio companies can be found in MicroVest's 2018 Social Impact Report under the metric Write-Offs/Average Gross Loan Portfolio: https://microvestfund.com/wp-content/uploads/2018/07/MicroVest-Social-Impact-Report-2018-Final.pdf

LOOKING TO THE FUTURE

Ongoing innovation – including new technologies, better education and greater scale – has helped lower rates in most countries. Technology is making it more efficient to reach MFI and SME clients digitally, reducing overhead costs. The expansion of financial infrastructure in many countries is paving the way for healthy competition, which in turn elevates the availability of innovative and affordable financial products. Similarly, more countries are establishing regulatory frameworks and credit bureaus for microfinance, enhancing the transparency and competitiveness of pricing.

MICROVEST'S EXPERTISE IN DUE DILIGENCE

MicroVest believes that the character of an institution's founders, management and owners are strong indicators of its financial viability. Any lender that treats customers unfairly will ultimately pose grave risks to any investor. To assess character and its impact for our portfolio, we put every potential investment through rigorous due diligence. We closely evaluate repayment rates, interest rates charged, collections policies and level of debt to ensure that an institution is treating clients fairly. We also go on-the-ground, meeting directly with the main office and a sample of branch offices and borrowers.

BORROWER SPOTLIGHT

Ms. Kzyzaibekova, client of KazMicrofinance (KMF)

Ms. Kyzaibekova has been a client of KMF for nearly two decades. An entrepreneur, she owns a sewing workshop that produces wholesale clothing and uniforms. Her story speaks to the powerful role that microfinance loans play in helping entrepreneurs develop their businesses.

Ms. Kyzaibekova first came across KMF when she had a business selling toys, shoes, and cosmetics at a local flea market. She started taking $100-$200 loans from KMF to purchase inventory. The productivity gains she achieved far exceeded the costs of her loans. In 2000, Ms. Kyzaibekova decided to start selling clothes. Since then, she has successfully scaled her business, which now includes government subcontracts for the sewing and provisioning of uniforms for multiple agencies. In February 2017, she took out a loan of $30,000 from KMF to purchase laser equipment for embroidering patches and to open an embroidery shop.

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