



Dr. Atiur Rahman
Governor, Bangladesh Bank

Microfinance Pricing Transparency

Keynote Address

Thank you very much for inviting me to speak a few words in front of this august gathering. All of you know that microfinance sector of Bangladesh has caught attention from all over the world due to its special nature of financial products for financially excluded sections of the society. In Bangladesh, the access of people involved in the economic activity in the rural market to banking services is not sufficient with respect to their contribution to GDP. According to Bangladesh Bank's statistics in FY 2008 the share of agriculture sector in GDP was 24% whereas the share of credit to this sector stood at 7% as of June 2008.

A large portion of the population of low income brackets both in rural and urban areas has a limited reach to the financial services. Therefore, financing this group of population for economic activity is a long standing demand that has been high on the agenda of the economists and the policymakers. Apart from agricultural credit of banking sector, Grameen Bank and non-government micro finance institutions (NGO-MFIs) are playing significant role through microcredit programs to boost up the rural economy in the country. With efficient disbursement and recovery position, their disbursement during FY08 amounting Taka 186.4 billion, is much higher than the agricultural loan disbursement of the banking sector. Microcredit sector in Bangladesh could indeed take pride on its substantial achievements especially in terms of outreach, sustainability and its impact on the borrowers. There is no doubt that microcredit can contribute in significant way to poverty reduction. However, microcredit program has to be integrated with macroeconomic policies.

To integrate these NGO-MFIs with the main financial market through a regulatory system, the government of Bangladesh established Microcredit Regulatory Authority (MRA) under "Micro credit Regulatory Authority Act 2006". This Authority is empowered and responsible to monitor and supervise the micro credit activities of these institutions. NGO-MFIs previously known as semi-formal sector now are being considered as part of formal financial market though there are many steps to go ahead.

Efficient pricing of microcredit requires that the interest rates charged on loans are market based, i.e, determined by the demand-supply condition in the microcredit market. However, some critical aspects of such type of loans prevented the market behave competitively. One factor is asymmetric information in the microcredit market which leads to large screening costs for the lenders and thereby higher interest rate to cover their costs. Besides, small loan size, operating and administrative costs are relatively higher in microfinance compared to other commercial loans. The following are important factors to consider when an MFI decides an interest rate:

- Administrative expenses, including rent and utilities, salaries, travel and transportation, office supplies, etc.
- Inflation and depreciation
- The cost of loan losses
- The cost of the funds that the MFI borrows from banks, refinancing source like central bank, low cost borrowers' saving
- Method- flat or declining?
- Amortization schedule- grace period benefits?
- Compounding periods- daily, weekly, quarterly, half-yearly or annually?
- Use of Information Technology (IT) can bring down operational costs
- Quality of governance also impacts operational costs (e.g. perks to top officials)

The Consultative Group to Assist the Poorest (**CGAP**) has designed a straightforward method to allow MFIs to determine what effective interest rate they need to charge in order to achieve financial viability. The interest rate required for financial sustainability is determined by five elements: administrative expense rate, targeted capitalization rate, loan loss rate, the market cost of funds rate, investment income rate.

Are the rates unreasonable? One approach is to compare MFI interest rates to the rates on other kinds of small loans that lower income people use. The idea is that making lots of small loans will inevitably cost more than making a few big loans, so what kind of rates are charged by other small lenders? The most powerful approach to the question of whether interest charges are too high is to look at the individual cost items that those charges cover (cost of funds, loan losses, and administrative costs) and the profit that's left over after paying the costs.

Recognizing Innovation and Efficiency. MFIs must find innovative ways to improve their productivity and efficiency, and reduce operating costs. Essential to this process is cost-reducing innovations. Government can help facilitate innovation in the microfinance industry by recognizing and rewarding innovators, thereby encouraging further innovation. Similarly, government can help ensure that information on more efficient MFIs is disseminated widely.

Financial and price transparency is one of the main steps among them. In economics, a market is transparent if much is known about:

- What products, services or capital assets are available;
- What price;
- Where.

There are two types of price transparency: 1) I know what price will be charged to me, and 2) I know what price will be charged to you. The two types of price transparency have different implications for differential pricing. A high degree of market transparency can result in disintermediation due to the buyer's increased knowledge of supply pricing. Transparency is important since it is one of the theoretical conditions required for a free market to be efficient.

In Bangladesh, central bank directly regulated price of financial products of banking sector for long time, which has been relaxed with the progress of deregulation. Banks have been advised to announce the mid-rate of the limit for the products different sectors and the banks may change interest 1.5% more or less than the announced mid-rate on the basis of comparative credit risk. However, this type of practice could not be introduced for the microfinance sector yet.

This seminar will help to understand how price transparency can be introduced for microfinance sector. I hope that business sessions will be fruitful to share views regarding current practice of NGO-MFIs and their pricing policies. I wish every success of this seminar. I would like to thank the organizer for their effort to organize this kind of important seminar.