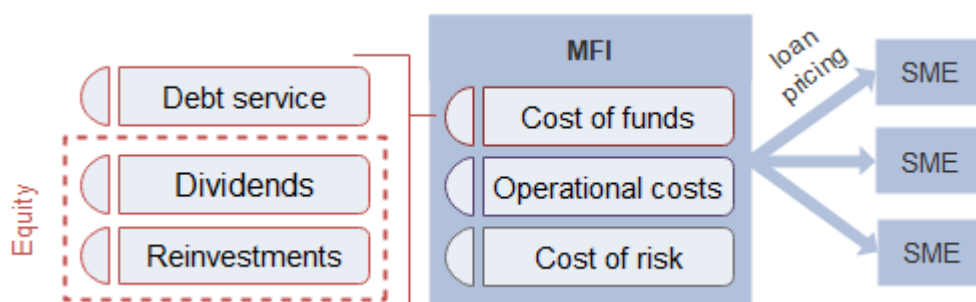


## Cost and pricing of microcredit

*how to balance financial returns and social benefits*

This short paper argues that microcredit, as a social enterprise, deserves free public sector support in line with the social (economic but non-financial) benefits it delivers to the public sector. It concludes that the EU budget based financial instruments should be provided for free and in any case, not at market price as it is sometimes the case currently.

Let's start with the basic equation of pricing of a financial product as follows:



End-price = cost of funds + operational cost + cost of risk where the cost of funds includes the service of debt and the return on capital; the latter includes dividends to shareholders as well as whatever re-investment is needed to ensure the sustainability of operations. Obviously, the outcome of this equation needs to be modulated according to the market supply and demand equilibrium.

There are differences between a commercially oriented business and a socially oriented one (such as microfinance in the EU) on each component of the end-price: the level of operational costs, the cost of funds and the perception of the cost of risk.

The cost of risk is generally perceived as higher in microcredit than in normal bank credit since the inclusion purpose entails that the client has little guarantee to offer if any. This is however not confirmed in practice and the loss rate of microcredit compares generally well with the loss rate of bank credit.

The operational costs of microfinance are much higher by construction since (1) it is more expensive to administer 100 loans of € 1.000 that one loan of € 100.000 and (2) there is a large spectrum of non-financial services provided – generally for free for clients – alongside the credit.

In itself, the pure mathematical implication of this should be a higher price for the poor, which is a general rule, even at country level. At the same time, the political objective of inclusion should entail that the social benefit of inclusion justifies rather a lower than a higher price for the poor. This poses the question of how to finance a lower price for a possibly higher risk and higher operational cost. The only variable that remains is the cost of funds.

There are several ways to lower the cost of funds, which are all based on the principle that public sector funds (in one form or another) are provided in exchange for social benefits rather than financial returns. It is clearly demonstrated that such social benefits also have a tangible positive economic impact.

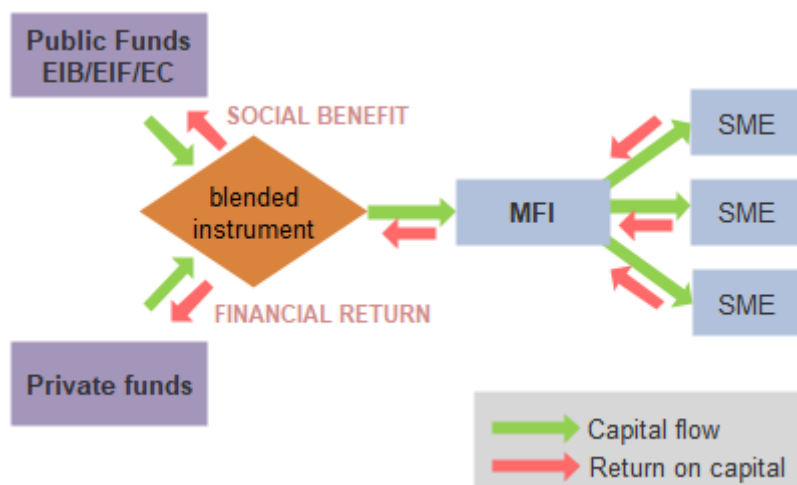
Public sector funds can be provided in several forms: public shares without dividends, free public guarantee, low or zero interest loans, straight subsidies (e.g. to support non-financial services) etc. Each of these options should keep in mind the objective of leveraging private resources at market price level. Indeed, the average cost of funds for microcredit intermediaries should be an appropriate balance between free public support and market price private resources. Free CSR funding from private sector can only remain marginal and temporary and cannot be the basis of a proper market development.

It is sometimes argued that the end price of microcredit to the client is too high compared to reference bank rates. However, as long as the return to private capital remains within acceptable limits and the risk and operational costs (efficiency) are optimised, a too high price can only derive from an inadequate public sector support i.e. one that does not reflect the social benefits delivered to the public sector.

This is where we should dig further rather than imposing any sort of cap on interest rates, which would only risk killing the sector rather than helping its beneficiaries.

In this framework, we would argue that the risk of loss and the consequent return requirement on an equity investment in (or interest rate on a loan to) a social microfinance enterprise should be balanced with the social impact. Indeed, the social objective of an investment can be fully achieved while, at the same time, the corresponding equity investment of the EU budget managed by EIF could be financially at loss at the time of exit. The question is: how to assess the value of social impact versus financial return and how to factor these into the pricing and performance indicators of the project.

The question thus arises of how to take account of risks AND social returns when pricing an EC/EIB/EIF financial instrument to a social purpose financial intermediary such as a social microfinance institution. As a bank, EIB/EIF cannot lower their costs or return requirements based on the social return, and they must always keep their risk-return equation balanced. This is where the blending with a grant element from the EU budget comes into play in order to lower the risk to EIB/EIF, be it in the form of a first loss piece, a guarantee or even a full funding. Obviously, for the social impact to be incorporated properly in the pricing/return, the grant element should be provided for free and should be in line with the expected social benefit. It is assumed that State aid rules do not apply in the case of social purpose organisations.



In turn, this raises the issue of the internal EIB/EIF/EC process to fix the price and/or return expectation. The EIB/EIF pricing is based on its own cost of funding, its administrative cost and the cover for risk. However, in this model, there is no account taken of the social benefit/impact unless the grant element

(equivalent to the social benefit) is fully integrated in the risk assessment and provided for free.

A second level of issues concerns where the benefit of the free grant ultimately ends up. For instance, if the MFI benefiting from a grant-supported instrument is a for-profit institution, it is pertinent to request that the benefit of the grant element be transferred in one form or another to the final beneficiary in order to avoid adding windfall profit to the intermediary and missing the social objective that is supposed to be reached.

However, in the case of a social purpose intermediary, such as a social MFI, the market gap – and thus the social objective – is at the level of the intermediary itself and the policy outcome is expected in terms of sheer volume of credit availability. There is thus no reason to request the transfer of benefit to the final client. One can see how a number of MFIs could simply not operate without the support of the grant element and, for instance, how some cases are already in trouble for the gap in availability of guarantees and funded instruments under EaSI.

This closes the loop of questions on the starting equation: a higher end price to the client results in undue transfer of resources from poor clients to private sector investors and to public sector organisations. The return to private investors must be in line with market references, taking account of public guarantees and other forms of support. The return to public sector must be considered as social rather than financial benefits.

Only if these principles are respected, will the operation have a real social impact, the clients an acceptable price and the private and public sectors an acceptable return.

This approach should be confirmed for the next generation of financial instruments of the EU, e.g. under InvestEU.