

Interest Rates and Self-Sufficiency

LESSON 1



THE ROLE OF INTEREST RATES

Interest is the amount paid by a borrower to a lender in exchange for the use of the lender's money for a certain period of time.

Money is a scarce resource. There is a limited amount of it, and it has value for everyone. Interest represents the cost of money – what a borrower pays in order to rent money for a certain period of time. Interest rates help determine the allocation of money because, as with other goods in the economy, the demand for money is influenced by its cost.

Interest does more than determine the allocation of money; it provides income to lenders. Interest is a cost paid by borrowers that enables lenders to provide an efficient lending service and to generate a reasonable profit. For microenterprise credit institutions, interest income determines whether the institution is dependent on donor funds or able to maintain itself with its own earned income.

For entrepreneurs who borrow, interest rates provide a "hurdle rate" over which investments must pass to be a valid use of scarce resources. If it costs an entrepreneur 9 percent to borrow \$1,000 for a year, then the investment must earn more than \$1,090 to be potentially worthwhile. Investments that earn 9 percent or less are inefficient uses of scarce financial resources.

In short, interest rates on loans are critical to borrowers, lenders, and the economy as a whole. The establishment of appropriate interest rates is crucial for the effective operation and financial management of microenterprise finance institutions.

Interest Rates from Two Perspectives

A. The Borrower's Perspective

Financial Costs are the interest and fees that borrowers pay to lenders in order to use the money for a specific period of time.

Transaction costs are indirect costs incurred to obtain loans.

Because transaction costs do not benefit either the lender or the borrower, lenders should minimize them to the greatest extent possible.

When a borrower approaches a lender for a loan, he is confronted with two different types of costs. The most obvious cost is the actual cost of the money, including the interest to be paid for the use of the loan, and the fees paid to the lender for processing and disbursing the loan. These costs are the financial costs of the loan.

The borrower must also pay transaction costs. Transaction costs are indirect costs incurred to obtain loans. They include bus fares to the lender's place of business, the cost of obtaining documents (like financial statements) required for the loan, the cost of the time spent by the borrower fulfilling the requirements for the loan, and any other costs related to acquiring the loan. Transaction costs also include costs due to inefficiencies in lender delivery systems, such as missed investment opportunities because of delays in loan disbursement; the extra time spent processing a loan because the lending institution misplaces a document, and others. Transaction costs are often greater than the financial costs if lenders are inefficient in their loan approval or disbursal process.

Financial and transaction costs represent the total borrowing costs of a loan. Because transaction costs do not benefit either the lender or the borrower, lenders should minimize them to the greatest extent possible. Financial costs, on the other hand, provide income to the lender in the form of interest and fees. Lenders that minimize transaction costs make it easier for their borrowers to afford higher financial costs. Financial costs should be established carefully by the lending institution in order to generate the income that the institution needs for survival and growth.

Given a fixed level of transaction costs, what level of financial costs can micro entrepreneurs afford to pay? How much in interest and fees can micro entrepreneurs pay and still benefit from borrowing money? These are controversial questions, and the source of continual debate in the micro enterprise credit field. The response depends on the profitability of the enterprises in question.

A financial analysis of microenterprises will usually show the activities to be quite profitable, enabling the entrepreneurs to pay financial costs equivalent to or higher than "commercial" rates¹ and still benefit from the loans. In some cases, however, when the level of profitability is extremely low, financial costs near commercial levels may represent an unbearable burden for certain activities. In such cases, loans may be an inappropriate intervention, and alternative mechanisms to promote economic development should be investigated.

B. The Lender's Perspective

There are three basic costs that lending institutions must cover with their income: the financial cost of the funds in their portfolio, known as the cost of funds, the cost of maintaining a loan loss reserve so that the portfolio does not decapitalize when loans are defaulted, and other operating costs that include the salaries of staff, rent, and other operating expenses.

To be self-sufficient, a financial institution must cover the above costs with income generated by financial services. For microenterprise credit institutions, interest charged on loans and fees associated with lending are the primary sources of earned income. The loan portfolio (funds lent to borrowers and funds on deposit available to be lent) produces a gross rate of return, or yield, which is the interest and fee income divided by the average portfolio. Self-sufficient lending institutions have a rate of return high enough to cover all of their costs, and keep the value of their funds from deteriorating because of the effects of inflation.

¹ Commercial rates refer to the interest rates charged by commercial banks for small enterprise of similar loans.

The diagram below shows the flow of cash for borrowers and lenders during a loan transaction. What the borrower pays in financial costs becomes the lender's income, which is used to pay for expenses. What the borrower pays in transaction costs is lost to both the borrower and the lender. The loan principal goes back and forth between the borrower and the lender.

