Why do MFIs charge interest on their loans to poor?

This is a frequently asked question. For most people, charging already poor people a high interest rate would seem to divert from any social mission.

A quick answer would be to say that MFI interest rates, though high, are much less than the extortionate rates charged by local money lenders – or loan sharks as they are often called. These rates can be as high as 20% per day.

A longer answer would be to say that microcredit interest rates are set with the aim of providing viable, long-term financial services on a large scale. MFIs must set interest rates that cover all administrative costs, plus the cost of capital (including inflation), loan losses, and a provision for increasing equity. Unless MFIs do so, they may only operate for a limited time; reach a limited number of clients; and will tend to be driven by donor or government goals, not client needs.

Why are microcredit interest rates higher than bank interest rates?

Rates are high because the costs of making a small loan are higher in percentage terms than the costs of making a larger loan. For example, if the actual cost per loan is $25, the percentage cost is 0.25% for a $10,000 loan, but 25% for a $100 loan. The percentage cost of making microloans is even higher because clients generally have no credit history, no collateral, are frequently illiterate, and often live in remote areas. It is expensive to go to these clients' doorsteps and intensively monitor repayments.

How can poor people afford such high interest rates?

Clients favourably compare microcredit interest costs to their overall business or household costs, their income streams, and informal financial alternatives. The poor consider access to credit more important than the actual interest cost.

- For a microentrepreneur, the cost of a microcredit loan represents a small proportion of total business costs. A 3-month $100 microloan with a 6% monthly interest rate, calculated on a declining balance, costs a client a total of $12.23. This generally represents less than 3.4% of a typical microentrepreneur's total costs.
- A poor entrepreneur, especially one engaged in trading, can generate greater benefits from additional units of capital than can a highly capitalised business, because she or he begins with so little. For example, the average annual return on investments by many of Opportunity's clients can be anywhere between 100-800%

Subsidised interest rates (i.e. lower than the market rate) generally benefit only a small number of borrowers for a short period. Interest rate subsidies distort markets and can encourage rent-seeking. MFIs that target specific populations with subsidised interest rates have generally suffered low repayment rates, institutional dependency, and limited growth. Clients often view these loans as one-off "gifts" that need not be repaid.

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