

“We encourage and support investees to apply fair, risk-based and transparent pricing for all financial products and services that is affordable to consumers while allowing for investees to be sustainable and provide balanced returns to investors. We strive to reassess and balance fair prices paid by customers and the return generated for investors / investees, based on a broader assessment of the risks impacting the DFS ecosystem, which includes: customers, providers and financial markets sector. For savings products, investors encourage and support investees to provide real returns on the deposits of customers.” - Investor Guideline #6

Promote Fair and Transparent Pricing

Investor Guideline #6

This Briefing Note is a result of internal activities of a Working Group of the Guidelines for Responsible Investing in Digital Financial Services. It is a draft version and serves as a basis for further consultation and discussion.

Briefing Note | Draft April 4, 2019

Responsible Investing in Digital Financial Services

Investor Guideline 6: Promote Fair and Transparent Pricing

Potential Actions for Signatories

Signatories may test, refine and adapt current industry evidence to be more relevant to their digital financial services investments, business models, market context, among other investment criteria factors. Potential actions for Signatories are based on recent industry examples and are not intended to be used as a compliance checklist given digital financial services standards and benchmarks are still evolving. Examples of potential actions may include:

- Review financial indicators, analyze the correlation of high effective interest rates (APR/EIR) with high return on equity (ROE) and assets (ROA), high NPLs/write-offs, low loan loss reserves, low administrative/distribution cost of digital lending, etc.
- Apply a combination of a market-based approach and a balanced return approach.
- A market-based approach compares, from the customer's point of view, the full price (i.e. the Annual Percentage Rate (APR) or the Effective Interest Rate (EIR)), product features and opportunity costs of the DFS provider's credit product to alternative offers in the market, such as credit products offered by banks, microfinance institutions (MFIs) and informal moneylenders.
- Balanced returns is an approach that considers operating expenses and profits when determining pricing. Considering that pricing decisions are based on cost of funds + operating costs + provisions + management's choice of profit, the objective is to balance the benefits for investors (return) with the benefits for customers (price). Balanced returns are particularly important for end-customers that are generally vulnerable, low-income people. The more vulnerable the customer segment, the stronger the focus should be on balanced returns.
- Review and consider the option of contractual agreements of interest rate reductions (gradually reducing the price paid by customers) based on the investee's financial projections.
- Consider the following pricing rationale for pricing decisions: in the early stage of development and growth of the investee, the initial cost of investment and operations may require relatively higher prices/costs. As economies of scale are reached, operating cost decrease and profitability increases, these benefits can be passed on to customers.
- For savings products, encourage and support investees to provide real returns on the deposits of customers.

Selected References

- Microfinance Transparency (MFT), [Resource Library](#)
- Microfinance Transparency (MFT), [Balanced Pricing in Microfinance Methodology](#), 2015
- Microfinance Transparency (MFT), [Pricing Analysis Tool](#) and [Calculating Transparent Pricing Tool – v3.0](#)
- MicroFinanza Rating, ['Field Evidence'](#), 2017
- Smart Campaign, ['Assessing Price Fairness in Microfinance'](#), 2016
- Social Performance Task Force, [Universal Standards for Social Performance Management](#)
- Microsave, ['Where credit is due'](#), 2017
- CGAP, Focus Note: [Consumer Protection in Digital Credit](#), 2017
- CGAP, Focus Note: [Doing Digital Finance Right](#), 2015
- SMART Campaign, [Client Protection Principles](#)

For Action

We encourage investors and signatories to [send comments or feedback](#) from actual projects and share actual practices from your own assessments to refine this tool for the broader investor community.

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Investor Guideline 6: Promote Fair and Transparent Pricing

Assessing the pricing scheme of a DFS provider (DFSP)

Responsible investors in digital financial services should apply a combination of a market-based and a balanced returns approach when assessing the fairness of the pricing of digital financial services (DFS). They should proactively incentivize DFSP to apply fair pricing and improve the transparency of pricing, terms and conditions for customers.

1. Fair Pricing - Market-Based Approach

DFSPs should compare, from the local micro-customer’s point of view, the full price per day / per year¹, product features and opportunity cost of the DFSP’s credit product to alternative offers in the market.

Info Box: The full price: APR & EIR

“Truth-in-lending”-legislation in countries around the world requires disclosure of the annualized effective interest rate either based on the APR formula ($APR = i * n$) or the EIR formula ($EIR = (1 + i)^n - 1$); the latter considers compound interest. For example, the APR formula is used in Bolivia, India and the USA, whereas the EIR formula is used in Ecuador, Mexico, the Philippines, Zambia and the European Union. The following practice examples show both calculation methods. See MFT-link, Pricing Analysis Tool“ under suggested references of this briefing note.

Example of market-based approach in a hypothetical country:

| Criteria | DFSP | Informal Money Lenders | MFIs | Banks |
|--|-------------------------|--|--|---|
| Interest per Day (all-in, inclusive of fees) | 0.4% - 0.53% | 0.83% - 1.0% | 0.15% - 0.28% | 0.05% - 0.08% |
| APR (all-in) | 146% - 193% | 302% - 365% | 54% - 102% | 18% - 29% |
| EIR (all-in) | 329% - 588% | 1,942% -3,678% | 72% - 177% | 20% -33% |
| Loan size and term | max. 500 LX; 30 days | 200 – 2,000 LX; typically 1 month | < 6,000 LX; 6 – 12 months | > 30,000 LX |
| Collateral | No collateral | Guarantor; | e.g. bank account, savings; group guarantee or guarantor | e.g. bank account, savings, collateral with assets; guarantor |
| Opportunity cost from end-client perspective | Lowest; mobile use | Highest; street visit in person; taxi ride to review client’s house, non-performance causes high penalty + visit by “informal police agents” | High; branch visit | High; branch visit |
| Regulatory framework | Tier 3 | No license | Tier 2+3 | Tier 1 |

Box colors are based on a “traffic light” concept: green = market strength, yellow = medium market position, orange/red = market weakness

¹ For comparison purpose, calculate the pricing in Annual Percentage Rate (APR) or Effective Interest Rate (EIR); including “interest + fees + tax + mandatory deposits”-calculation (if available). MicroFinance Transparency’s database and calculation tools can be used for that purpose (www.mftransparency.org)

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Practitioner guidance: Under current early-stage DFS market conditions, interest rates are higher than local MFIs/banks, but lower than “black-market loan sharks”. This market-based comparison allows responsible investors to assess the fairness in a first-step approach of the DFSP product from a client’s perspective, considering additional factors such as opportunity cost (qualitative assessment of time-, lost economic income- + travel-expense to alternative providers).

2. Fair Pricing - Balanced Returns Approach

Balanced returns is an approach which considers operating expenses and profits in a general pricing assessment. Considering that pricing decisions are based on cost of funds + operating costs + loan loss provisions + management’s choice of profit, the objective is to balance the benefits for investors (return) with the benefits for customers (price). Balanced returns are particularly important for DFS customers who are vulnerable, low-income clients. The more vulnerable the customer segment, the stronger the focus should be on balanced returns.

Responsible investors should review financial indicators and analyze the correlation of high effective interest rates (APR/ EIR) with high return on equity (ROE)/ return on assets (ROA), high NPLs (incl. write-offs), low loan loss reserves, and low administrative/ distribution cost of digital lending. Not acceptable would be triple digit interest rates (>100%), double digit NPL (>10%), low admin cost that overall would result in an excessively profitable financial situation.

Considering that most DFS providers are still loss making today, but expect high returns after break-even, it is crucial to analyze and assess pricing in the context of the business plan and financial projections.

Practitioner guidance: In the early stage of development and growth of the DFS provider, the initial cost of investment and operations may require relatively higher prices. As economies of scale are reached, operating cost decrease and profitability increases, these benefits can be responsibly shared with customers. In an efficient and transparent market, this trend is supported by rising competition. The deliberate reduction in prices over time, as profitability increases, should be factored into the business plan and could be agreed upon with responsible investors.

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Example of balanced returns approach with hypothetical financial projections

| Actual and Expected Financial Results - Base Case | | | | | | | | |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Indicator / year | <i>Real</i> | <i>Real</i> | <i>Real</i> | <i>Plan</i> | <i>Plan</i> | <i>Plan</i> | <i>Plan</i> | <i>Plan</i> |
| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 |
| Total Assets | \$100.000 | \$130.000 | \$195.000 | \$292.500 | \$526.500 | \$947.700 | \$1.611.090 | \$2.416.635 |
| Loan Portfolio (Net) | \$80.000 | \$104.000 | \$156.000 | \$234.000 | \$421.200 | \$758.160 | \$1.288.872 | \$1.933.308 |
| Number of Customers | 5.000 | 6.500 | 9.750 | 14.625 | 26.325 | 47.385 | 80.555 | 120.832 |
| Total Revenue (interest + fees) | \$116.800 | \$151.840 | \$199.680 | \$257.400 | \$383.292 | \$689.926 | \$940.877 | \$1.063.319 |
| Equity | \$100.000 | \$130.000 | \$195.000 | \$292.500 | \$526.500 | \$947.700 | \$1.611.090 | \$2.416.635 |
| Profit After Tax | -\$20.000,0 | -\$19.500,0 | -\$19.500,0 | -\$14.625,0 | \$26.325 | \$94.770 | \$322.218 | \$531.660 |
| Capital & Liquidity | | | | | | | | |
| Equity Ratio | 100% | 100% | 100% | 100% | 100% | 100% | 100% | 100% |
| Liquid Assets / Total Assets | 40% | 30% | 30% | 25% | 25% | 25% | 20% | 20% |
| Asset Quality | | | | | | | | |
| NPLs 30 days | 40% | 35% | 30% | 15% | 11% | 10% | 10% | 8% |
| NPLs 90 days | 30% | 20% | 15% | 10% | 10% | 8% | 7% | 6% |
| Write-Off Ratio | 30% | 20% | 15% | 10% | 10% | 8% | 7% | 6% |
| NPL 90 days Coverage Ratio | 100% | 100% | 100% | 100% | 100% | 100% | 100% | 100% |
| Open Credit Risk Ratio | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| Customer retention rate | 70% | 75% | 80% | 85% | 88% | 88% | 88% | 90% |
| Loan application acceptance rate | 90% | 50% | 30% | 25% | 20% | 20% | 20% | 20% |
| Efficiency | | | | | | | | |
| Cost-to-Income Ratio | 175% | 160% | 140% | 110% | 95% | 70% | 60% | 55% |
| Profitability | | | | | | | | |
| ROE | -20,0% | -15,0% | -10,0% | -5,0% | 5,0% | 10,0% | 20,0% | 22,0% |
| ROA | -20,0% | -15,0% | -10,0% | -5,0% | 5,0% | 10,0% | 20,0% | 22,0% |
| Revenue / client | \$23 | \$23 | \$20 | \$18 | \$15 | \$15 | \$12 | \$9 |
| Profit / client | -\$4 | -\$3 | -\$2 | -\$1 | \$1 | \$2 | \$4 | \$4 |
| Pricing | | | | | | | | |
| Interest rate per day | 0,40% | 0,40% | 0,35% | 0,30% | 0,25% | 0,25% | 0,20% | 0,15% |
| Fees | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 |
| APR all-in | 146% | 146% | 128% | 110% | 91% | 91% | 73% | 55% |
| EIR all-in | 297% | 297% | 237% | 185% | 141% | 141% | 103% | 71% |

This table serves as an example of the evolution of a hypothetical DFS provider over time. The development of the interest rate levels are in line with development of profitability. Pricing levels are decreased whereas profitability rises to satisfactory levels.

3. Contractual Agreements for fair pricing

Responsible investors should focus on the potential for interest rate reductions (gradually reducing the price paid by customers) based on the DFSP's financial model projections.

Practitioner guidance on pricing policy:

Does the DFSP apply a risk-based pricing? Good practice examples include pricing policies where interest rates are determined by different credit scoring classes, rewarding clients with lower probabilities of default as well as repeat clients. Other price differentiating factors, such as purpose, loan size and tenor are applied.

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Practitioner guidance on pricing structure:

Does the pricing consist of an all-in interest rate or is the total price broken down into various pricing components, such as interest and fees? Good practice examples include all-in pricing. It makes meaningful comparison across various offers feasible for the end-clients.

Early Repayment should be possible at all times at a fair price (or without extra fees taking into account the overall interest pricing level).

Practitioner guidance on investor’s finance condition/funding clauses:

Does the agreement between DFS provider and investor implement fair pricing elements? Good practice examples show that investors can agree on a one-time reduction of effective interest rates to customers prior to their investment or they can contractually agree on a step-down interest rate reduction tied to certain milestones linked to the financial projections of the DFS provider.

- (a) Examples of milestones in the investment process include subscription/ signing of contract, conditions precedent to disbursement, capital increases, etc.;
- (b) Interest rate reductions may also be included along with other client protection principles in broader ESG action plans;
- (c) Examples of key milestones in the financial projections include the breakeven of the investee as well as reaching certain profitability thresholds.

Example of a two-phased interest rate reduction clause:

| Contractually agreed price reductions between investor and investee | Pricing prior to investment | Phase 1: first disbursement | Phase 2: second disbursement |
|---|-----------------------------|-----------------------------|------------------------------|
| First-time clients | 0.35% (128% APR) | 0.25% (91% APR) | 0.15% (55% APR) |
| Repeat clients | 0.25% (91% APR) | 0.20% (73% APR) | 0.10% (37% APR) |

4. Transparent pricing

DFS providers should disclose pricing, terms and conditions in a clear, complete and timely manner. Pricing should be communicated in a transparent and standardized way in order to allow customers to meaningfully compare offers in the market and make informed decisions.

Practitioner guidance on transparency: Interest rates should ideally be disclosed as an all-in price in annualized terms (APR/EIR), as this is the most meaningful measure of comparison and in line with truth-in-lending legislation around the world. At the very least, the interest rate per day as well as any additional fees (such as up-front fees, prepayment fees, etc.) should be clearly disclosed.

Pricing, terms and conditions should be presented, transparently and directly on screen (i.e. no link to separate page) before the customer enters into the contract.