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Does Efficiency Lead to Lower Prices? A New Perspective from Microfinance Interest Rates[1]

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In microfinance, high interest rates are a topic of intense debate urging accounting for their motivation.

This article contributes to the debate by providing empirical evidence of the impact that the efficiency of an MFI has on its microcredit interest rate.

The data envelopment analysis framework is used to estimate financial and social efficiency.

The financial efficiency of MFIs has helped to reduce microcredit interest rates. There is, however, no impact of social efficiency on interest rates.

Pricing is a central strategic decision for all companies, and is particularly sensitive for social enterprises with both financial and social objectives. High interest rates in microfinance are a topic of intense debate. Using an original database of 291 MFIs, this paper provides empirical evidence of the impact the efficiency of an MFI has on its microcredit interest rate. We use the non-parametric Data Envelopment Analysis (DEA) framework to calculate efficiency and differentiate financial and social efficiency. The results show that financial efficiency has a positive impact on interest rates, with more financially efficient MFIs having lower interest rates, while social efficiency has no impact on microcredit interest rates.

Pricing is a key strategic decision for all companies, and is particularly sensitive for social enterprises with both financial and social objectives, such as microfinance institutions (MFIs) (Milana and Ashta, 2012). The main objective of MFIs is to provide affordable financial services to poor and low-income households. Therefore, MFIs have a 'double bottom line' of financial and developmental or social objectives.

High interest rates have been defended in the name of sustainability (Kar and Bali Swain, 2014). Interest charged on loans is the main source of income for these institutions. MFIs face high administrative costs because of the low amount of the loans and therefore they charge high rates, frequently above 30% per year (Cull *et al.*, 2009; Armendáriz and Morduch, 2010). These high interest rates have been criticized since the 1970s, but the criticism has recently intensified (Hudon, 2009, 2011; Rosenberg *et al.*, 2009). Some MFIs have been closed down by local authorities, partly because of their interest rates. A short while ago, a cap on interest levels was set by the central bank of Bangladesh, the leading country in terms of microfinance.

[1] JEL classification codes: G21, L31, L25.