SPTF Social Investor Working Group Webinar
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Title: Promoting Fair and Transparent Pricing
Moderator: Jürgen Hammer, SPTF
Speakers:

- Lory Camba Opem, IFC
- Dr. Thomas Koch, DEG
- Jessica Espinoza Trujano, DEG
- Isabelle Barrès, Smart Campaign

- **Jurgen Hammer (SPTF)** noted that this webinar is meant to generate discussion among responsible investors on implementing the Guidelines for Responsible Investing in Digital Financial Services. This webinar will focus on Guideline 6: Promoting Fair and Transparent Pricing, and the Social Investor Working Group is planning to hold additional webinars on how to practically implement each of the other guidelines.
- **Lory Camba Opem (IFC)** provided overview of the Guidelines.
    - She said IFC has been investing in DFS space for 3-4 years. “As much as the opportunities we saw, we were seeing similar risks that we’ve been seeing in traditional microfinance,” she said.
    - IFC began talking with the Responsible Finance Forum and Goodwell about these risks, and she said they noticed that other investors were also increasingly interested in defining what it means to responsibly invest in digital financial services. Based on that, IFC brought a group together to draft what would later become the Guidelines.
    - The Guidelines are anchored in the G20 High-Level Principles for DFS because the Principles already incorporate issues from the Smart Campaign Client Protection Principles, the BTCA, and CGAP. “We didn’t want to start from scratch; we wanted to really build on what was already there and move forward quickly because digital is moving quickly,” she said.”
    - Lory listed the 10 Guidelines, which are housed at the Responsible Finance Forum:
        1. Promote Responsible Investment in Digital Finance
        2. Manage Risks Comprehensively with Growth of Digital Inclusion.
        3. Foster a Proportionate Legal and Regulatory Framework
        4. Facilitate Interoperability and Infrastructure for DFS Ecosystems
        5. Establish Customer Identity, Data Privacy, and Security Standard
        6. Promote Fair and Transparent Pricing
        7. Improve Disclosure of Terms and Conditions for Customers
        8. Enhance Customer Services for Problem Resolution and Product Innovation
        9. Prevent Over-indebtedness, Strengthen Digital Literacy, and Financial Awareness
        10. Track Progress to Mitigate Risks and Expand DFS Opportunities
- **Dr. Thomas Koch (DEG)** introduced the brief that DEG developed as part of Guideline 6. He said the discussion of excessive interest rates in the fintech sector reminds him of a showdown in a Western movie. “There’s a client asking for a microloan, and there are three other dudes who

are offering a microloan at interest rates which could be about 1% per day," he said. "This is the real world we see in the fintech market."

- He said DEG takes both a market-based approach and a balanced returns approach when assessing pricing.
  - Market-based approach: Responsible investors should analyze the overall market scenario from a client's perspective to make a country- and product-specific assessment.
    - Investors should compare pricing from digital financial service providers, informal money lenders, MFIs, and banks, and they should use criteria such as interest rates, loan size, collateral, and opportunity cost in that comparison.
    - **Jessica Espinoza Trujano (DEG)** provided an example taken from an actual investment proposal, which compared pricing of digital financial service providers to informal money lenders, MFIs, and banks. The example compared interest rate per day (including fees), loan size/term, collateral, and opportunity cost from the end-client perspective (e.g., how difficult is it to apply for the loan?)
      - With the DFSP, the interest rate per day is between 0.4-0.53%. the loan size is relatively small and the loan term is relatively short. No collateral is required, which makes it appealing to a client. There's also a low opportunity cost because no travel is required to go to the branch.
      - Collateral requirements are stricter for the other offerings in the market compared to DFSPs.
      - On the other hand, the interest rate per day for fintechs is high compared to MFIs and banks. This is partially due to the smaller loan sizes. It's still lower, in this case, to informal loan sharks or money lenders.
  - Balanced-returns approach: Responsible investors should analyze the correlation of high effective interest rates (APR/EIR) with high return on equity (ROE), high NPLs, and low administrative cost of digital lending.
    - Thomas said, from DEG's perspective, it would not be acceptable to have triple-digit annualized interest rates, double-digit NPL, and low admin costs, which would result in an excessively profitable financial situation.
    - Jessica noted that when looking at the balanced-returns approach, it's important to look at the overall business plan and the overall business projects. She provided an example of a hypothetical fintech case. There's a typical projection seen in fintech investments:
      - It starts with significant losses and investments upfront, coupled with relatively high NPLs. As the algorithm becomes more sophisticated, the portfolio grows. As the portfolio increases, the number of clients goes, as do total revenues. Portfolio quality becomes more stable, and the cost-to-income ratio improves. The institution becomes profitable over time, and that allows us to reduce interest rates over time.
      - In this case, the interest rate per day started at 0.35%; after year 5, the plan was for it to be 0.15%.

        - Thomas noted that this is a hypothetical example. "In the real world, each fintech is different, and the projections will be different."
    - Practitioner experience for promoting fair pricing.
        - Guidance: Responsible investors should focus on the potential for interest rate reductions. Analyze it and discuss it with fintech investees.
            - Criteria 1: pricing policy
                - Rewarding clients with lower probabilities of default/repeat clients?
                - Price differentiating factors (i.e. purpose, loan size, and tenor)?
            - Criteria 2: pricing structure
                - All-in pricing?
                - Meaningful comparison for end-clients?
                - Early repayment possible without additional fees?
            - Criteria 3: DFSP funding clause for responsible investors
                - A one-time reduction of effective interest rates?
                - A step-down interest rate reduction tied to milestones?
    - Practitioner experience with pricing transparency:
        - Responsible investors promote that interest rates should ideally be disclosed as an all-in price in annualized terms (APR/EIR).
        - Follow "truth-in-lending" legislation, which typically uses the APR or EIR formulas.
        - In the fintech space, this is very rarely the case. For the time being, we should at least expect that the interest rate per day, as well as any additional fees, should be disclosed. That at least provides the clients with some comparisons. But still, APR is the ideal.
    - Where do we see the fintech in 5 years? Thomas said that some investors could be seeing positive returns, and there could be regulators at ease in the future. "We see more active regulators who will review this, currently niche, part of the financial sector and see it grow significantly," he said. "We will see in the future responsible investors who will create added value to clients and economic value to countries."
- **Isabelle Barrès (Smart Campaign)** described how DEG's briefing note complements work done on fair and transparent pricing in the inclusive finance sector. She said the draft guidance note is very much aligned to what the Smart Campaign Client Protection Principles (CPPs). She provided a timeline of the work done on these issues:
    - *Sept 2009* – Smart Campaign launched the initial CPPs, which had transparency and responsible pricing lumped together. She said they used to think of the transparency angle more, as pricing is hard to evaluate. "Often when we think about pricing, we don't often think about pricing for what," Isabelle said. "And that for what is important. You could have a product that is priced at exactly at the same level, and one is responsible and one is not because of what the product terms are or what the value is to the client."
    - *Dec 2009* – Smart separated transparency and responsible pricing into two different principles. "To determine whether or not a price is fair, you first need to have access to pricing information. Especially if you're taking about any market-based approach that requires comparing prices to others in the market," she said. "We felt it was important to separate the two to give them the attention they required and needed." Smart collaborated

with MFTransparency (MFT) until its closing. MFT's analysis included interest rates, as well as any hidden fees, mandatory savings, loan terms, etc. W

- *July 2010* - Smart commissioned research to inform the evolution of standards for responsible pricing. "This principle has been the most challenging because there are so many different elements of pricing and so many reasons why a price might be what it is," she said. "Our thinking here on what makes a price fair has evolved. When we updated the standards, this is an area that has consistently been under review. How could we think more about balanced returns?" She said balanced returns assumes we're able to quantify/measure/articulate what is fair and affordable to clients and what enables the clients to be sustainable. That's what this research focused on. It also tried to frame the research from a client perspective.
- *2012* - SPTF launches the Universal Standards for Social Performance Management, which integrates the CPPs.
- *January 2013* – Smart launches the Smart Certification program. This made it important to have more precise guidelines for determining whether or not an organization was meeting the standards. Additional guidelines were incorporated into the certification program to make sure there was harmonized analysis across portfolios and across organizations that were certified and that there was a common understanding of what the application of these standards actually meant in practice.
- Isabelle said that in an ideal world, markets are going to drive prices down and hold FSPs accountable. But there were and still are some markets where prices were higher than neighboring markets across the board.
  - What happens in markets that aren't competitive? What happens in markets that are showing monopolistic or oligopolistic forces, where we can't trust that prices are going to come down? How can we assess not solely on peer analysis?
  - It puts the onus more on what the provider is doing, regardless of what's happening with its peers. "You could have a FSP that's not pricing products responsibly but just has peers that are also not pricing responsibly," she said. "They could just be the best of bad players but still not good enough at protecting clients." To address this, Smart worked with Daniel Rozas (MIMOSA, e-MFP) and Lucia Spaggiari (MFR) to come up with a framework to go beyond the market-based approach in a more systematic way, with clearer guidance.
  - From the beginning, the campaign was not only focused on the market-based approach, but Isabelle said it wasn't clear enough what that meant. It wasn't clear what the benchmarks would be going beyond market-based pricing and toward a balanced return approach. The rationale for that was that markets are all at different levels of maturity and not always functioning well. There are also markets that have market leaders, which raises the question of whether the leading institutions should be held to higher standards, given that they influence the entire market).
  - In some markets, peer data was scarce, making it difficult to get into the implementation.
  - Daniel came with some more specific parameters around what a balanced return approach would look like, disaggregating the pricing elements. Not just looking at overall pricing and efficiency levels, which is what Smart had focused on before. The new parameters included other elements, like the quality of the portfolios through the loan loss reserves, cost of funds and return expectations.

Coming up with parameters around these price elements would help guide the analysis of whether a price is responsible.
        - The ranges were done in coordination with the Social Investor Working Group, in terms of returns expectations.
        - "The ranges that came out of this effort were never meant to be pass or fail but to guide analysis, raise red flags, and help focus on areas that would be more problematic but still allow the flexibility to determine if it made sense to have these exceptions," she said. She added that we know some exception can be justified, that pricing is complicated and there are a lot of elements that could explain higher prices.
        - MFR is managing a new data platform, which would in many ways replace the role that MFT played in terms of having a good benchmark for pricing. Isabelle said this will be instrumental in doing the level of needed market analysis.
    - Isabelle said the client protection standards are currently being updated for digital credit. She said the pricing approach is very much aligned with DEG's discussion of market-based and balanced returns approach.
        - "What's still needed is experimentation, especially with digital credit providers," she said. "More than ever, we need to have more data to come up with acceptable ranges. What are levels that are going to raise red flags?"
        - She said the industry also needs to better understand the reality of these providers in terms of the different stages of maturity that fintechs go through. Smart found with the new standards that prices are indeed much higher. There are expectations that the prices will go down, but we haven't seen that, she said. "We need to see examples where the promises around pricing are really translating into actual results and reduction of pricing," she said. "We may be ok with more experimentation in the early stage of a fintech, but we definitely want to see some reduction in pricing and some demonstration that the organization is living up to its stated policies as it matures."
    - She said Smart Campaign is interested in continuing to work with others on developing briefs and implementation guidance for the Guidelines. It's best to coordinate to minimize the number standards and guidelines that providers or investors are asked to adopt.
- **Laura Foose (SPTF)** if Isabelle had any comments on DEG's briefing note. Isabelle said it would be helpful to have some clear, common understanding of what implementing a balanced approach or a market-based approach means. It will require additional guidance of the types of ranges or parameters that are deemed to be acceptable vs not. "We can ensure a more harmonized approach to this, which is important from the provider perspective," she said. "They need to know what to work toward and have a better understanding of what the expectations are going to be and how they're going to reviewed and evaluated."
- **Lucia Spaggiari (MFR)** provided a brief overview of the Data Platform, which is meant to centralize data on pricing, client protection, social and financial performance from FSPs from many sources, including investors.
    - She said that having a place where the information can be pulled together will be beneficial. Because pricing is so complex, the Data Platform will have tools that allow APR or MPR compared to size of loan, terms of loan, as well as guarantee, inflation, and other parameters.

- Because the platform includes financial and operational data, it's possible to compare profitability, portfolio quality, etc. to other legitimate reasons of higher prices, such as rural outreach, management compensation, or quality of infrastructure.
  - Lucia noted that this is just one of the pieces of the puzzle that may be potentially used by investors in assessing responsible pricing.
- Lory noted that the conversation about pricing has to be driven by responsible investors. What are investors and their partners expecting in terms of returns? "When you're brining in a VC where this is a sliver of their portfolio, this isn't something they would think about right away," she said. "It's not an easy discussion."