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The Art and Science Of Pricing Financial Services

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October 2006

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Pricing a financial service is both an art and a science. The "art" of pricing is in choosing a combination of fees and charges acceptable to customers, that are fair and transparent, and in determining if the product has any unique attributes that deserve premium pricing. The "art" of pricing is in careful and considered communication to and feedback from customers and staff to ensure that pricing messages are appropriately and correctly delivered. The "science" of pricing is in ensuring that the product is profitable and is competitive in the market, that aside from very few specific and chosen loss leaders, that each products returns a profit.

This short paper briefly examines pricing from the customer perspective to examine how important price is as a determinant of customers' choices and why prices of financial services are so difficult for users to understand. It considers the pricing implications of the evolution of "traditional" microfinance to a more "market led" approach. The paper reflects on theory and practice, with an emphasis on the later in particular the significance of transparency and mechanisms and policies to improve transparency of pricing. A simple, but effective pricing methodology is introduced that considers, the cost of provision, the charges of competing products and the value of the product to customers. The paper ends with consideration of factors relevant for pricing different types of financial services, including savings, loans and e-banking products.

PRICING AND THE CUSTOMER

How important is the price of financial services to poor people?

Participants in focus group discussions carried out by *MicroSave* consistently raise pricing issues. Clearly the price of financial services and the manner in which customers are charged are important. However, several observations suggest that accessibility to financial services is more important to poorer people than price, for example, the losses the poor typically face when obtaining services from the informal sector are quite high, yet they still use these mechanisms. Also existing services accessed by the poor such as deposit collectors prevalent in West Africa are very successful and charge relatively high fees. Specifically Mukwana and Sebageni note below from their qualitative research in Uganda that for savings products price was given much less frequently as a reason for choosing financial service provider than the safety and security of the institution and the ease of access to savings.

Reasons for Choosing Financial Service Providers-Savings (Mukwana and Sebageni, 2003)

Position	Reason
1	Physical appearances (i.e. of premises, guards, weapons etc.)
2	Ease of access to savings (liquidity of savings)
3	Perceptions of institutional stability
4	Ownership
5	Interest paid on savings
6	Working hours

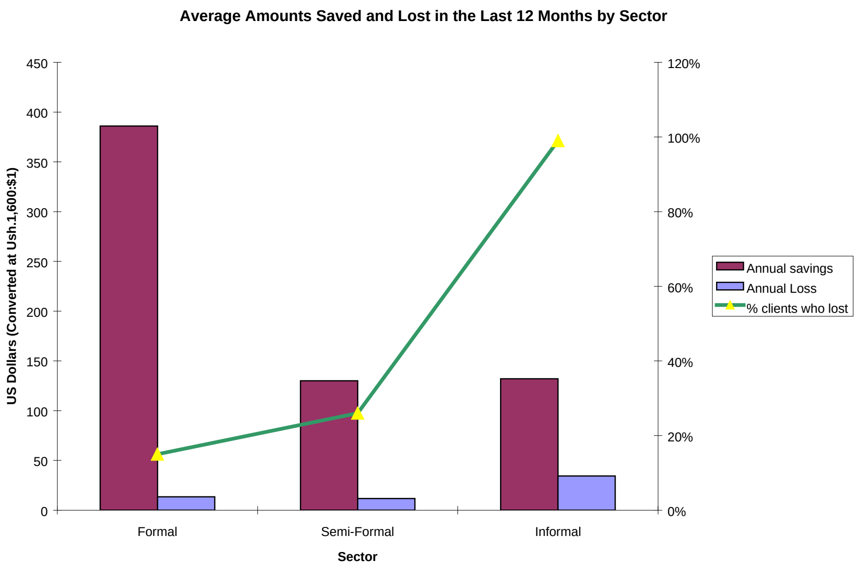
Stuart Rutherford's research identified a broadly similar set of priorities, in six key factors sought after by the rural poor when they are considering where to entrust their savings (Rutherford, 1996). These are:

1. *Safety*: Will savings be held safely by the bank or other deposit taker?;
2. *Ease of withdrawal*: Can savings be accessed when needed?;
3. *Proximity to home or workplace*: Are there nearby locations for making deposits and withdrawals?;
4. *Prizes or bonuses for good saving*: Can more be earned for diligent savers?;
5. *High interest rates*; and
6. *Quality of services*. Are small depositors treated with respect and appropriate assistance?

High risk of losses from informal and semi-formal services: The safety theme raised by both researches is of paramount importance. In Mukwana and Sebageni's research concerns for safety are echoed in physical appearance, perceptions of institutional stability and ownership.

Very often poorer people use semi formal and informal mechanisms to manage money, for example savings in kind, savings at home, reciprocal lending, savings clubs such as RoSCA's and ASCAs', savings with a supplier, and non reciprocal lending.

Research by Wright and Mutesasira (below) suggest that the total losses through participation in semi-formal and informal mechanisms are high. However, the continuing use of these high-risk services suggests an ability and willingness among many poorer people to pay a significant price for an appropriate level of accessibility and service.



Source: The Relative Risks to the Savings of Poor People (Wright and Mutesasira, 2001)

Frequent transaction behaviour: Poor people often need to transact small amounts of money, frequently. Stuart Rutherford gives the example of a Rickshaw puller in Bangladesh. When asked how much he could save in a month the Rickshaw puller replies Taka.10, when asked how much he could save in a week he replied Taka.10, when asked how much he could reply in a day he said Taka.10. Why, because that was the amount of disposable income that the Rickshaw puller had available at a moment in time. This answer demonstrates an important principle that, transaction based services for low-income people should be designed and priced appropriately for higher volumes of low value transactions. Often this implies a small charge applied frequently and transparently rather than a larger fee applied infrequently.

Why is pricing financial services so difficult for customers to understand?
Consumers find it difficult to compare products and services; this is because financial services are by nature intangible. Even when comparing simple deposit accounts, fees and charges differ for different services, for deposits, withdrawals, transfers, for opening accounts etc. In other cases different services are bundled together, for example compulsory savings and microfinance loans, where clients view compulsory savings as a cost of borrowing rather than a valued service. Worse still price information is overwhelming, customers simply cannot compare the products and services for more than a handful of competing institutions.

To make matters even more complex the cost of the service is only a portion of the total costs to clients. Customers often endure several cycles of small loans, and countless meetings before they obtain the loan they require. Informal costs typically include, transport to meetings, waiting time, meeting time, and paying delinquent group members loans and on occasion even facilitation payments to loan officers!

When accessing formal sector services there are other barriers, a typical process to open a savings account in a Ugandan Bank for example includes a letter from the local council, two passport sized photographs, a mandatory reference letter from existing clients, queues to open accounts and sometimes several trips to collect the account card or passbook. In some countries additional barriers are imposed for low-income clients due to Know Your Customer / Anti Money Laundering legislation, which requires proof of customer's address before they can hold a bank account.

Pricing and Microfinance

Mainstream microfinance is in transition from a product driven to a more competitive, market led approach. The more customer responsive market led approach is characterised by more competitive markets and a focus on efficiency, product diversification and delivery channel development, each of which have implications for setting and communicating prices.

Competition: More microfinance markets are becoming competitive; for example Bangladesh, Uganda and Bolivia. Moreover, the range of institutions providing services to the low-income market is growing. A recent CGAP presentation provides the following figures of 750 million deposit accounts targeted at low income consumers more than 50% are held in Postal Savings Banks, 36% in Agricultural and state banks, and only 5% in traditional NGO based microfinance programmes (CGAP 2005). Simultaneously microfinance is increasingly integrated into the financial system, microfinance products are frequently offered by a department within a bank, for example Cooperative Bank in Kenya, CRBD in Tanzania, and Hatton National Bank in Sri Lanka. Pricing now has to take account of this wide range of competing institutions.

Efficiency: There is a greater focus on efficiency, driven by a more competitive environment, greater standards of disclosure by initiatives such as the Microbanking Bulletin and the Microfinance Information eXchange (MIX), and more aware policy makers. It is becoming harder for microfinance institutions to price high to cover inefficient operations.

Product Diversification: When CGAP published "Occasional Paper Number 1 Setting Sustainable Interest Rates" microfinance was often seen as the preserve of microcredit focused NGO MFIs offering a single basic product. In this environment, pricing could be reduced to a cost plus formula:

$$\mathbf{R = [(AE + LL + CF + K) / (1 - LL)] - II}$$

Where R was the required minimum sustainable rate, LL the loan loss, CF the cost of funds and II investment income. While the principle of cost coverage remains a vital aspect of pricing, in a multi-product environment pricing itself becomes more complicated. Different types of products, savings, insurance, group and individual loans, all need to be priced individually. So, what can be learned from pricing theory?

PRICING THEORY

Pricing theory is important for a several reasons, but one in particular is worthy of note; establishing a price for a particular product or service is often delegated to the marketing function. In part this is justified on the basis that research is required in order to establish competitive prices. However, marketing departments staffed by marketing professionals have often received a lengthy orthodox menu of pricing theory from marketing training and marketing manuals. These approaches, though valuable tend to surround pricing with an almost mystical aura. The actual practice of pricing financial services can be very simple as demonstrated in the section entitled "How to Price Products," but first some theory.

Pricing Objectives

In "Marketing: Theory and Practice" (Baker, 1995) Diamontopolous suggests a framework for pricing objectives and methods as shown below:

Pricing Objectives		
Profit • Money profit • Gross/net margin • Contribution margin • Return on sales • Return on capital employed • Return on net worth • Profit growth	Volume • Market share • Sales volume • Sales revenue • Sales growth • Capacity utilization	Financial • Cash flow • Earnings per share • Price earnings ratio • Dividends
Competition orientated • Marching/undercutting competition • Avoidance of price wars • Limit entry • Price stability • Money profit	Customer orientated • Fair price levels • Goodwill • Value for money • Full price range • Price maintenance in the channel	Miscellaneous • Projection of high quality image • Avoidance of government intervention • Survival/security

Inevitably, where demand for financial services is price sensitive, a lower price leads to a significant increase in demand. However, where demand is greater than supply, as in most microfinance markets, price is not the limiting factor. Neither for many microfinance institutions subject to achieving a stated level of return, is profit maximisation a key driver[1]. One possible addition to the pricing objectives given above is when an institution prices high in the short term to obtain sufficient profits to finance expansion and geographic outreach.

Pricing as a Marketing Strategy

Marketing textbooks, by such guru's as Kotler, discuss using price as a competitive strategy. Commonly quoted strategies include:

- *Penetration Pricing*: Setting prices at an artificially low level, for a relatively short period of time in order to penetrate an established market.
- *Loss leaders*: Using loss making products to secure business, either through cross selling, or through obtaining future business from that customer, exploiting the idea of the lifetime value of a customer.
- *Skim Pricing*: Setting prices at an artificially high level in order to obtain a smaller volume but high value of sales. Often done to recoup initial investment in product development at smaller volumes.
- *Keep Out Pricing*: Setting prices at a price often below total cost of production in order to protect a particular market, or market segment, from competition.
- *Mark Up*: A simple pricing methodology is to apply a profit percentage on to an existing cost base.
- *Target Rate of Return*: Establishing a target rate of return and pricing products to achieve that return.
- *Value Based Pricing*: Pricing products related to the institution's perception of the value of the product to the customer.

However, several of these strategies are questionable, if not inappropriate in the low-income financial market, for several reasons. Firstly, the majority of microfinance markets are immature and so institutions do not need to adopt aggressive pricing strategies. Secondly, in many markets setting artificially high prices is often difficult for microfinance programmes to justify to their customers or to external stakeholders. Thirdly, other non-economic factors, such as mission to serve the poorest have led to heavy subsidies in some donor-supported programmes. A thorough approach to pricing is given later, but two strategies are worth considering now, penetration pricing and loss leaders.

[1] A notable exception to this is possibly the South African microlending industry, which is discussed later.

Penetration Pricing: Transformed microfinance institutions that can accept deposits, or non-bank financial institutions frequently offer higher interest rates on savings to attract deposits to finance their loan portfolios. As illustrated by PRIDE Uganda, a transformed microfinance institution and Stanhope a Non-Bank Financial Institution in Uganda, which offers interest rates a few percentage points higher than those of larger banks.

Loss Leaders: Loss leaders are products deliberately priced at a loss making level. Such products typically include children's accounts, church accounts and lotteries. For example, Cooperative Bank in Kenya offers a children's deposit account call Jumbo Junior, on which it is prepared to loose small amounts of money in order to generate lifetime loyalty from future customers. Often larger institutions have offer a children's account because it is popular with parents or is seen as a must have account. Costing exercises show that children's accounts consistently loose money but that losses are modest.

Pricing and Consumer Behaviour

Llwellyn and Drake (2000) argue convincingly that pricing influences customer behavior, for example, an explicit transaction charge will reduce the number of withdrawals made, is of relative benefit to customers with a low volume of transactions, and is transparent. In contrast a fixed fee, provides certainty of costs, but effectively provides a subsidy to clients with a high volume of transactions. The properties of different pricing modes are examined further in the following table:

Properties of Pricing Modes

	Induces cost reducing behaviour	Implicit cross subsidies	Cost/revenue interest rate sensitive	Benefit to low volume transactions	Certainty of costs	Subsidy to large volume transactions	Transparency
Explicit transaction charge	4	8	8	4	8	8	4
Fixed quarterly fee	8	4	8	8	4	4	4
Zero interest on balances	8	4	4	-	4	-	8
Minimum balance	8	4	4	-	4	-	8
Fixed quarterly fee including x transactions	(4)	4	4	4	(4)	8	4
Differential transaction charges	4	8	8	8	8	8	4
Rebates on basis of balances	8	4	4	8	8	8	8

Source: Llwellyn and Drake (2000)

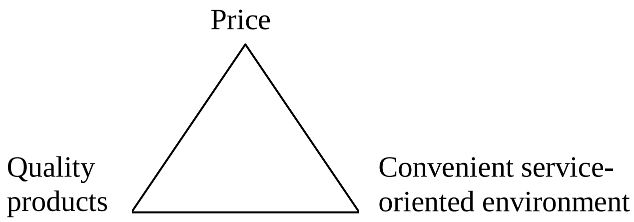
4 - has impact 8- has no impact (4) – can have impact under certain circumstances

Llwellyn and Drake's analysis has practical application. Teba Bank's "Grow With Us Account" provides a practical example of the impact of the nature of pricing on customers behaviour; Teba Bank charged a ledger fee, which over time reduced many accounts to a zero balance. This was giving Teba Bank an increasing reputation risk given that many depositors' balances were not growing but shrinking. The bank re-priced the account.

Some financial institutions actively use pricing to change the way customers behave. In Uganda Standard Chartered was experiencing crowded banking halls. When it introduced ATMs the bank decided to re-price its services to encourage customers to use automated services. It charged a high over the counter fee, and a much lower ATM based fee. At the same time it launched a publicity and education campaign to explain the use of the new machines to its customers. In Kenya, Kenya Post Office Savings Bank (KPOSB) offers services through Post Offices in Kenya in addition to its network of dedicated branches. However, Post Offices frequently have limited liquidity, so to discourage large immediate withdrawals KPOSB imposes a premature withdrawal fee.

Using Price as a Differentiator

Using price to differentiate an institution from its competition can be dangerous. A simple perceptual map, given below suggests that there are at least three important differentiators, namely price, quality products and a convenient service-oriented environment.



However, to compete on price alone, means operating on very low margins and being hostage to other institutions being able to offer services more efficiently and being able to out compete on price. Particular care should be taken when making promises on prices, an East African financial institution uses the tag line "Quality Service With Better Terms – Always", the difficulty is that every customer will have a different idea on what "Better Terms" actually means. This could result in the institution failing to meet customer expectations.

HOW TO PRICE PRODUCTS: COST, COMPETITION AND VALUE

At a strategic level many of the marketing approaches to pricing remain options, but they don't always provide in depth guidance on *how* to price products and services. *MicroSave* recommends a three-tiered approach to pricing. An institution should first establish the *cost* of providing the service through product costing. Secondly, the fees and charges given by the *competition* should be considered. Thirdly, the features of the product should be compared against the features of competing products to determine whether there is additional *value* in the product that can be premium priced. Other pricing strategies, such penetration pricing and skim pricing should be considered only after these steps have been taken.

Cost: There are two related methodologies for establishing the cost of a product, namely allocation based costing and activity based costing. In allocation based costing, costs are allocated normally on a line-by-line basis of the profit and loss account to the different products offered, on the basis of a logical reason for allocated those costs. Activity Based Costing (ABC) costs individual processes, such as loan appraisal, or opening an account by closely observing the inputs to a particular process. Activity Based Costing enables customers to be charged on the basis of the cost of individual processes. More details about allocation based costing can be found in *MicroSave*'s Costing and Pricing Toolkit (Cracknell et al, 2004), more details about Activity Based Costing can be found in CGAPs Product Costing Toolkit (CGAP 2004).

Competition: Establishing the fees and charges provided by the competition for similar products and services takes time. In some countries there are market intelligence agencies that maintain a detailed database, which can be purchased periodically. However, most institutions will need to discover this for themselves through in-depth market research. It is important to collect information on the complete range of fees within competing products, as this help an institution see where it has a competitive advantage.

So for example when Teba Bank priced its Grow With Us Savings Account, it compared its account with those of 6 other competitors, on the basis of 23 different fees and charges. These included monthly fees, stop orders, debit orders, statements, deposits, transfers, withdrawals, balance inquiries and a range of ATM based transactions.

One of the challenges that financial institutions face, is that the fees and charges of its competition change frequently, so there is likely to be a degree of misalignment of prices. The objective should be not to maintain exactly the same price structure, but to retain a pricing structure that is not far out of line with that of the competition.

Value: The third element of the pricing strategy is to establish whether the product or service being offered has any additional value to the customer, which can justify premium pricing. How is this done? On one level it is a very simple exercise, *MicroSave* recommends that directly competing products and services are measured qualitatively against each other using the 8Ps of financial marketing. The 8Ps are product design, price, place, promotion, people, physical evidence, process and positioning. A recap of the 8Ps is produced in the table below.

8 P	**Description**
Product Design	Includes specific features of the product, such as terms and packaging, loan review and disbursement time, collateral or guarantees, grace periods, amortisation schedules and repayment structures.
Price	Includes the interest rate, loan fees, prepayment penalties, prompt payment incentives and for savings products ledger and withdrawal fees as well as interest paid to the account holder.
Place	Refers to the accessibility of the services and the distribution mechanism used by the financial service provider.
Promotion	Includes advertising, public relations, direct marketing, and personal selling as well as sales promotions – in short, everything that the financial service provider does to promote its corporate image and its products.
People	Includes how the people involved with delivering the product – in other words, the staff of the MFI, treat clients. Are clients treated with the courtesy and attention befitting a customer? Are they made to feel welcome? Are they helped to understand the products and the MFI's policies and procedures?
Physical Evidence	Includes the presentation of the product and the systems to deliver it. Physical evidence therefore includes how the branch physically looks, whether it is tidy or dirty, newly painted or decaying. This P also covers the physical appearance of the brochures and posters, as well as appearance of the staff.
Process	Includes the way or system through which the product is delivered. This encompasses what the client has to do to effect the transaction, how the transaction is processed and documented, the queues or waiting involved, the forms to be filled out, and so on.
Positioning	Is the effort by the MFI to occupy a distinct competitive position in the mind of the target customer. This could be in terms of low transaction cost, low price, high quality of customer care, quick turnaround time, professional service, etc. One of the least tangible of the 8 Ps, Positioning is a perception.

The Eight P's of Financial Marketing

Benchmarking can be used to establish value. Equity Bank in Kenya spent time researching competitors through gathering secondary data on pricing, and through mystery shopping. They used their own staff to measure the services offered by competing institutions. The exercise took a small team of staff a total of three weeks to perform. A key output of the exercise was a benchmark of where Equity Bank stood relative to competing institutions on a variety of different quality measures.

A more direct way of establishing value, is of course, to ask customers, using Focus Group Discussions and Participatory Rapid Appraisal Tools[2]. Particularly useful is *Financial Landscape Analysis*. This analysis consists of taking a competition matrix, which compares products across competing institutions using a framework comparing the 8Ps of financial marketing[3], and then asking customers to provide comments.

There are many examples of value based pricing. In Bangladesh, BURO, Tangail a popular microfinance programme, is able to charge higher than average interest rates on its loan products, largely because customers appreciate BURO basket of more flexible services. Deposit collectors in West Africa charge fees for daily collections services. Equity Bank in Kenya charges an additional transaction fee for its mobile branch banking services. Western Union is able to premium price its money transfer product, as it is one of few companies offering money transfer services to recipients without a bank account.

[2] For more details on qualitative research methods see *MicroSave's* materials on Market Research for MicroFinance available on www.*MicroSave*.net
[3] These are: Price, Place, People, Product design, Process, Promotion, Physical Evidence and Positioning

In theory value based premiums in competitive markets, should act as a signal to competing providers to offer the service at a reduced premium. Over time the feature or set of features that justifies premium pricing becomes a standard or must have commodity. In BURO Tangail's case, when Grameen launched a comprehensive range of new products it had to reduce its own fees and charges. Another example in many developing countries is the ATM card, which initially is targeted to highly valued customers at a fee, and as infrastructure rolls out is increasingly offered as part of a normal deposit account.

PRICING IN PRACTICE

Transparency

From a customer perspective one of the most important aspects of pricing is the degree of transparency of the products fee structure, without this customers are simply unable to compare financial services between institutions. This is clearly demonstrated in *MicroSave*'s Competitive Environment in Uganda study in 2003:

Price as a determinant of Customer Behaviour

Clients have repeatedly cited interest rates as one of the top determinants of their choice of the financial service provider from which they borrow. But the quantitative study reveals that only 11% of the sub sample of those currently borrowing had "shopped around" multiple institutions prior to taking their loan. Furthermore, as Hudson (2003) notes, "Less than 10% of those respondents that had loans at the time of interview have changed supplier in the past 2 years based on price (although price is the most common driver of churn)". Clients feel that the prices they are paying for loans are high, but are unable or unwilling to search for better deals.

The qualitative studies help us understand that clients are more likely to be unable than unwilling to "shop around". It is transparency or communication of pricing (or rather the lack of it) that prevents clients from differentiating between suppliers on this basis. As Mukwana and Sebageni (2003) stress, "It must be noted however that although clients said that they took price into account, when they were pressed for detail, they did not seem to know the actual details of the interest they paid on their loans. So even though they said interest was important to them, they did not really know the differences in interest charged by different providers on their loans. It is probably realistic to conclude that although clients say interest rates influence their choice of providers of credit services, the reality is that this is not the case – simply because of the lack of clear documentation and communication of effective interest rates by MFIs". The obfuscation of prices/fees means that the competitive environment is not working for the clients on price in the same way as it is in other aspects of the product (group- v. individual-based lending, reduced compulsory savings requirements, grace periods, lengthening loan terms etc.). This presents an important challenge to the microfinance industry, and an opportunity for the MFIs to differentiate themselves on the basis of transparent and fair pricing

The Competitive Environment in Uganda Synthesis (Wright and Rippey 2003)

Common confusions arise over descriptions of interest rates as "flat", "declining balance" and even "annual declining balance". Although customers are well aware how much they pay, they are often not aware of what they actually pay for, for example in some institutions loan insurance is bundled into the interest fee, and in other cases an explicit fee is charged.

When Equity Building Society (now Equity Bank) performed market research on customers' perceptions, they found that many customers considered them more expensive than the competition because they calculated and expressed their interest on a declining interest rate. Worse still, customers disliked the range of fees and charges they were made to pay. At the time Equity imposed a range of sundry charges for photocopying and phone calls, which were neither well communicated to customers, and were applied in an ad-hoc and arbitrary fashion.

Fortunately, improving transparency can have immediate positive impact. Equity reviewed interest rates and restating them in clear concise client language. Brochures were printed outlining the product changes, and tariffs were displayed in banking halls. The changes took effect on January 1st, 2002. In the words of Gerhard Coetzee et al, (2002) in their study "The Rebirth of Equity Building Society" client response to these changes was impressive.

> *"The results of this initial product refinement were marked by an overwhelming client response towards Equity as an institution and its products and services. To test the effect of the market research, Equity decided not to aggressively market the new refinement measures but instead monitor to see what responses would ensue that could be attributed solely to the market research exercise. Soon after the market research, the number of accounts opened in a day jumped from an average of 20 – 30 to about 200."*

Transparency and changing pricing: Occasionally financial institutions decide to change their pricing. This can be a difficult communications message if the prices are being revised upwards, especially for an institution that is competing on price, or in a highly competitive market. In some cases it may be possible to "repackage" the pricing on the product, to move for example, from a declining to a flat rate calculation, or to increase fees for in demand services, whilst reducing others.

Improving Transparency

Customers often act on the basis of perception, rather than fact, a point whose significance is not lost on leaders of microfinance programmes:

> *"We need to keep the perception that we are low cost compared to the market, we do this by having a lesser volume of charges which are competitive, while offering high value services. Our problem now is growth, we don't want to sacrifice customer loyalty for immediate returns"*
>
> Ugandan MFI leader

Customers' perceptions are often heavily influenced by the degree of transparency in pricing, even if prices in the more transparent institution are higher.

> *"At U-Trust we price more or less in line with the competition, one challenge is that people complain that we have too many fees and charges. They equate the volume of charges and therefore the frequency of application with being expensive which is actually not so, when detailed comparisons are carried out."*

If improving the transparency of pricing is of value to customers, and can be of great value to enterprising banks, the question becomes how can this be done? This section indicates a range of approaches used by *MicroSave's* Action Research Partners.

Schedule of payments: A schedule of payments is often used to show customers how much interest and principle they will pay on different loans of different maturities, or how much interest they can earn on fixed deposits or contractual savings products.

Tariff guides and brochures: Tariff guides can be produced either as posters or brochures. A poster should be framed and hung in prominent position, in accordance with its perceived importance to the customer.

Frequently Asked Questions guides: Written guidance to staff can be issued on how best to respond to customers' questions on pricing.

Simplification of fee structures: New products in the Kenyan marketplace have started to offer all-inclusive fees, which provide a regular user of banking services with a range of banking transactions for a single fee.

Understand customers pricing preferences: Many successful institutions take time to understand the perceptions of customers related to the types of fees and charges levied. Typical research methodologies adopted include:

- *Focus Group Discussions / Individual interviews*: Focus group discussions and individual interviews are used for a number of reasons. Firstly, to understand customers' perceptions of prices. Secondly, to decide how to express prices to customers in clear, concise, client friendly language.
- *Participatory Rapid Appraisal Tools*: These are tools used with customers to elicit responses, *in particular simple preference ranking* – which examines the features of a particular product with customers and *relative preference ranking* – which compares customers' perceptions of different features between institutions.

Careful analysis of the competition: While institutions cannot watch all prices all the time, they do have much greater capacity to monitor the price of a range of financial services than their individual customers. It is then important that this information is collected, analysed and used to assist staff to explain prices to customers.

Explaining complex pricing: Where fees and charges or interest receivable has a complex structure, it becomes very difficult to appear transparent to customers. Equity Bank launched the Jigenge contractual savings account in 2003. It was more complex than Equity's standard savings account, in that the interest received was dependant on the amount and regularity of savings by the customer. To explain this, Equity Customer Service Advisers used a spreadsheet, showing returns to the customer for investing different amounts regularly. Equity found that the product sold relatively well, but only while advisors were available to explain the product carefully to customers. It was a valued product in that 90% of customers who used it renewed the contract on its expiry.

Regulatory Approaches to Pricing

There are many regulatory approaches to pricing financial services. In many countries there are usury provisions that are designed to prevent the application of very high interest rates. Around 40 countries apply interest rate ceilings. Most countries mandate disclosure of fees and charges, which are reinforced by industry codes of conduct. In Kenya the Central Bank publishes comparative fees and charges of banks on a quarterly basis. In many countries detailed guidelines are provided on the calculation and publication of interest rates such as Annual Percentage rates or effective rates.

Interest rate ceilings: CGAP published a very thorough and interesting paper on the impact of interest rate ceilings "CGAP Occasional Paper 9 - Interest Rate Ceilings: The Story So Far" (CGAP 2004). This paper shows that interest rate ceilings apply in more than 40 countries, however, it queries the effectiveness of interest rate ceilings as it often tends to restrict the supply of funds to the low income sector.

> *"Although interest rate ceilings do not have the desired effect, concerns about the high costs of microfinance and predatory lending practices remain valid. Competition however, is the single most effective way to reduce both microcredit costs and interest rates. Policies to promote competition among credit providers, combined with relevant truth in lending laws, can go a long way toward expanding the reach of sustainable microcredit while safeguarding consumer interests"*

CGAPs concerns on the high costs of loans in some markets appear to be borne out in South Africa. See box below.

Pricing Consumer Credit In South Africa

"The average charge for mortgages and pension backed loans [is] between 15-19% per annum compared to the average cost of small short-term micro-loans, which cost consumers around 222-360% per annum. In general, low-income consumers pay the highest rates for credit with the shortest maturity, unless they have access to security such as property, pensions or insurance policies…."

"The generalized practice of benchmarking prices provides respectability to rates that may not reflect the risks involved and means that regardless of size of provider, or size of loan book, providers in similar market segments charge similar rates. This suggests that either these prices reflect the real costs or that competition is not effective. … In particular, high returns from credit activities are associated with:

- Captive consumer market segments. This may be a consequence of location, such as where providers are located on the employer's premises, or a consequence of tied relationships between the employer and the provider.
- Poor disclosure and vulnerable consumers. This is often a consequence of both consumers and providers reinforcing the notion that there is restricted choice.
- An ability to sell related or tied products, such as credit life insurance.
- A capacity to minimise operational costs. This may be a consequence of economies of scale; or preferential access to funding or collection mechanisms; or an ability to negotiate bulk discounts on information; or access to an exclusive information set; or a combination of the above."

Extracts from The Cost, Volume and Allocation of Consumer Credit in South Africa (Hawkins 2003)

The case of South Africa clearly demonstrates the need for public transparency on pricing. This can be achieved partly through the publication of effective rates, an important element of the "truth in lending laws" mentioned by CGAP above. For South Africa these principles have been enshrined in the creation of the Microfinance Regulatory Council (MFRC) and the National Credit Act (2005), and a range of supporting legislation.

So is the South African industry anti-competitive? Taking a longer period between 1992 and 2004, a study produced very interesting results – despite the conclusions derived by Hawkins above the South African micro-lending industry is becoming *more* competitive and that prices are in fact falling in the most expensive short-term 30-day category, with interest rates in 2000 typically over 500% per annum (ECI/IRIS 2005 pp 25-29), compared to 222-360% above. It is too soon to determine the impact of the National Credit Act (2005) on pricing. However, while in the short term the costs of compliance may in fact drive up prices as banks seek to maintain margins, in the medium term the impact of improved transparency *should* continue to exert a downward pressure on pricing. The National Credit Act introduces specific consumer protection measures, as outlined in the box below:

The National Credit Act: Showing a Role for Government in Promoting Transparency.

The South African Department of Trade and Industry wrote the following in a presentation on the then National Credit Bill, 2005: "The National Credit Bill introduces specific consumer protection measures, for the credit industry in South Africa. The bill: -

- **Establishes a set of consumer rights** – including the right to confidential treatment, accurate information, reasons for the refusal of credit, information in an understandable language and a choice in the manner in which documents are received. It also prohibits unfair discrimination in the extension of credit
- **Introduces comprehensive consumer protection measures** – e.g. introduces standards for contracts and pre-contractual disclosure and measures to reduce reckless lending; prohibits false, misleading and deceptive advertising; provides for the registration of credit bureau and the regulation of consumer credit information; provides relief for over-indebted consumers and a new scheme for the voluntary surrender and the repossession of goods."

Effective Interest Rates
The total impact of fees, charges and compulsory deposits on the total cost of lending for a consumer can only truly be seen through the calculation of effective interest rates. Effective interest rate calculations take into account all cash flows around a loan. These include, the initial disbursement of a loan, the repayment instalments, any compulsory deposit, application fees, monitoring fees and commissions[4]. Note that even effective interest rate calculations have methodological problems in that to compare loans, they have to compare loans with similar amounts and loan terms.

What is not easily apparent is the range of effective interest rates that can apply to loans, which have similar headline interest rates. In a detailed review of micro-leasing products Mutesasira et al. (2002), it was noted that headline interest rates varied between 15-30%, but when *MicroSave* calculated effective interest rates (on a total cost to customer basis) these ranged between 34% and 124% per annum. The most expensive elements of the loan to customers was often not the interest rate applied on the product, but rather the impact of sizeable compulsory deposits and deductions, even though compulsory deposits were returned to customers after their loan had been repaid.

In the European Community, effective interest rates need to be shown in all advertising material. All financial services should express prices in a consistent form, called the Annual Percentage Rate. This shows the effective rate for a loan including standard charges brought together in an effective rate calculation for a period covering one year.

Comparative publication of fees and charges: In a recent move to enforce greater transparency of fees and charges, the Central Bank of Kenya (CBK) started to publish fees and charges on common accounts, such as current accounts, business loans, personal loans etc., for all 42 registered banks in Kenya. This is normally accomplished through a full-page advertisement published in the two national newspapers, the Nation and the Standard.

Misdirection
While transparency of financial information should be encouraged, an institution pricing transparently can find itself at a disadvantage when competitors misuse pricing information. The messages given out by staff of financial institutions on the pricing of competitors' products is often “highly selective”. Slightly unethical misdirection nevertheless appears to be a common practice, examples provided include:

- Alluding to declining balance interest as cheaper than flat rate interest without disclosing relative figures.
- Quoting flat rate interest without specifying basis of calculation to appear cheaper loans charged on a declining balance basis.
- Describing all in one fees as cheaper than the charges of competitors, when in fact a typical user of a competitor’s product does not use every feature.
- Using confusing terminology to describe the basis of interest calculation such as “annual declining balance” (which for an annual loan produces a rate equivalent to that of a flat rate loan.)
- Adding additional upfront fees and charges, and then in promotions choosing to disclose only partial information on fees and charges.

Penalty Fees
The pricing and application of penalty fees needs careful consideration. The reason for penalty fees is primarily to discourage certain types of customer behaviour that costs the financial institution. The most common penalty applies to late payment of loans, or insufficient funds in a deposit account payment. Other penalties are applied to cover the costs of additional monitoring visits, letters and legal fees or in the case of deposit accounts overdrawn balances.

[4] Guidance on how to calculate effective interest rates is available from a variety of sources including www.dti.gov.uk/ the annual percentage rate and total charge for credit in consumer credit regulations.htm and Ledgerwood (2000), pp 139 - 152

The challenge comes because some fees and charges are poorly understood because they are rarely applied. Misunderstandings arise at both customer and staff level. In a branch of an Action Research Partner, when staff had limited time to spend opening accounts, the account opening requirements were carefully explained but the less common fees and charges levied on the account were not. This approach led to widespread dissatisfaction among clients, when they discovered that fees had been applied.

Worse still discretionary or occasional charges that require human intervention to raise the charge, are frequently not applied by staff. After extensively revising its procedures through process mapping Equity Bank in Kenya realised that they were failing to apply some penalty charges for late payments on a new loan product. With attention focused on compliance to policies, Equity Bank staff now started to charge the fees and penalties designed into the product. While this aided repayment rates the penalties were seen as new charges, and led to the perception amongst some that Equity Bank was no longer its listening caring financial partner.

Fees and charges should be applied regularly, and in a manner that is as transparent to customers as possible. A particular difficulty arises when customers transact infrequently on their accounts and so have limited contact with their financial institution, for example, passbook holders in a Postal Savings Bank. There are many cases where customers come to transact on a dormant account to find that ledger fees have completely eroded the balance of their savings.

Mainstream banks, are aware that clients often react strongly to the application of penalty fees, and are careful to communicate regularly with customers through bank statements that both record transactions, and on the reverse state common penalty fees clearly. However, deposit-taking microfinance programmes often issue statements on demand or on collection due to the cost of delivery of statements and the fact that some clients do not have a postal address. In addition these statements are often not used to communicate fees and charges.

Technology

Technology is becoming increasingly important in banking and microfinance, the use of technology has important implications for pricing. Technology makes it much easier to charge fees and charges that vary with customer behaviour, for example to move from ledger fees to transaction based fees. Conditional charges and penalty can be applied, for example if customers move beyond an agreed overdraft limit, or are late in repaying a loan. Grace periods can be tracked. Deficiencies in a banking system are often noticed during product development, refinement or re-pricing.

Accommodation of pricing structures: In some cases the design of the banking system can impose a treatment of fees or charges, for example, on one banking system popular in East Africa the entire interest for certain types of loan is calculated on disbursal of the loan and charged to the loan account and a balance sheet asset is created which is gradually expensed.

It is important to ensure that the banking system used can accommodate a range of fees and charges, so that if necessary the pricing structure of a product can change, for example, moving from a declining to flat method of interest calculation, or introducing a grace period on a new agricultural lending product.

Automatic application of fees and transfers: Wherever possible fees and charges should be applied automatically. When FINCA Uganda introduced a new product – the Small Enterprise Partnership Loan it carried a penalty fee for late payment. However, the system was not able to apply the fee as designed, instead the fee had to be manually applied through manual journals, with frequent late application of fees.

In introducing its new Finacle banking system Equity Bank is trying to automate the charging of as many fees as possible, so that fees are driven online real time by the transaction occurring and do not wait either for end of day processes or manual processing. Equity managers believe that this automatic posting will save them a considerable workload.

PRICING SPECIFIC PRODUCTS

Pilot test and pricing new products
Where it is difficult to price products, pilot tests can be used to establish the willingness of people to pay for a particular service. During a pilot test, however, the pilot test team should recognise the principle of "pricing high" during the pilot test. This is for a very pragmatic reason. It is far easier to reduce prices on the rollout of a new product, than it is to increase them.

During the development of a new product it may not be possible to establish a full cost for delivering the product. At this stage, the institution has to rely on a financial projections model to establish the most likely break-even point for the product at a give range of prices and costs. It is only when the product has been fully rolled out that a product costing can establish conclusively whether the product is making money.

Pricing Savings

People have different motivations for saving money. In the broadest sense, these motivations can be defined as transaction based - people need to have money to facilitate transactions, precautionary – people need to retain money to meet unforeseen events or to plan for an uncertain future and speculative – people invest money for high returns. Products, their fees and returns reflect these motivations as reflected in the table below.

Motivation	**Type of account**	**Accessibility**	**Basis of fees**	**Typical interest paid**
Transaction	Current account, ordinary savings account.	Instant	Transaction based fees	Graduated interest rates based on account balances.
Precautionary	Long term savings accounts, contractual savings accounts.	Instant with fees or with notice period	Interest spread	Higher interest than ordinary savings account
Speculative	Fixed deposits for larger amounts.	Limited or nil until maturity	Interest spread	High interest rates, often based on market returns

In longer term accounts there are often no explicit fees and charges. Instead fees are implicit they are based on offering a lower return to the customer in interest paid than the institution can earn through investing the deposits.

Graduated interest rates: Graduated interest rates are a common way for institutions to offer higher interest rates for larger deposits. Graduated interest rates have a number of advantages for the financial institution. Firstly they minimise total interest expense for the institution, secondly, they allow a single savings account to appeal to customers with different motivations, thirdly, graduated interest rates enable the institution to perform some attractive promotion and marketing based around the higher interest rates.

Ledger fees verses transaction fees: Research throughout East Africa, using qualitative research tools, such as relative preference ranking has consistently indicated that low income clients prefer to be charged for the financial services that they initiate rather than to be charged a ledger fee. A transaction based fee has the added advantage that it rewards the efficiency of the institution, in that, the more transactions it is able to process in a given infrastructure the more profit it is likely to make. Gradually Action Research Partners have been responding to this perception of the market and have moved to charging for transactions.

Bundled Fees: Few clients understand fees that encompass a range of services. A typical example of this is in the case of FINCA Uganda, which included loan insurance premiums in the interest it charged to customers. Other MFIs, which quoted this fee separately were perceived to be less expensive that FINCA Uganda, when this was not in fact the case.

Transforming Institutions and Pricing Savings

Microfinance institutions, which become licensed to accept deposits, face multiple challenges. They need to convince customers to trust them; that they are a safe, secure place for savings over a prolonged period. Part of the solution is to portray the right image and to create an appropriate infrastructure (Cracknell 2005), but another challenge is to price their new savings products appropriately. Transforming microfinance institutions are caught in a dilemma. On one side they want to use savings to finance their growing loan portfolio, on the other they lack the credibility to attract widespread deposits. One solution, often adopted by niche Non Bank Finance Companies is to premium price their savings products, and offer a higher than normal return for deposits. Recent competition analysis in Uganda showed that Stanhope, a Non Bank Finance Company was offering interest rates of up to 10% per annum, where other financial institutions offered between 3 – 5% per annum.

The question then becomes how to price deposits in an attractive way, without incurring high levels of additional cost. The answer lies in careful research and segmentation, followed by offering graduated interest rates, which increase with the amount of savings deposited. Initial segmentation research by *MicroSave* has suggested that a relatively small number of depositors make up a large proportion of the balance in institutions targeting the low-income sector.

Commercial Microfinance Limited, a Non-Bank Financial Company in Uganda tried another approach to attract deposits, rather than price their savings accounts high, they decided to offer a short-term lottery for all new deposit account holders. The danger of a lottery is two fold, firstly that other banks respond with lotteries of their own and it becomes merely a hygiene factor, something that customers expect, and that increase the cost for all banks, and secondly that it attracts speculative deposits for the purposes of entering the lottery rather than high value savings accounts.

The Impact of Inappropriate Pricing

TPB's Quick Account appeared to be very successful; it was attracting significant deposits from the public. A review at the Arusha branch revealed that a small number of depositors held 55% of outstanding deposits by value. On review it was discovered that for higher savings balances the interest rate margin on the product was actually negative! Treasury Bill rates were falling but TPB did not make a corresponding shift in the interest it paid to depositors as rates had already reached historically low levels.

Equity had just achieved the highest rating of any financial institution under the GIRAFE rating methodology. It was growing rapidly and was popular amongst its clients. Amongst its product range was a fixed deposit offered at highly competitive interest rates negotiated on a deal by deal basis. When costing showed fixed deposits to be losing money, Equity tied the fixed deposit interest rate to the rate prevailing on Treasury Bills.

KPOSB noted that its Premium Bonds prize pool was greater than the income being generated from investing the premium bonds. The product costing made the problem more transparent. KPOSB responded with a new promotional campaign, a new needs assessment, and a new prize structure.

Source: Cracknell and Sempangi (2002)

Pricing Loans

Many factors should be considered when pricing loans aside from cost, competition and value the institution needs to consider the pricing method, whether flat or declining balance, pricing for larger loans and whether there can be differential pricing to price for risk to reward good customers.

Flat verses declining balance: There can be strong institutional and client preferences for calculating interest rates using either the flat rate or declining balance method. A flat rate is often considered transparent and easy for customers to understand, because it charges the same amount of interest every period. The declining balance method is often considered fairer because it only charges interest on the amount of the loan outstanding. The challenge in many respects relates to transparency between institutions, particularly because loans attracting a flat rate of 15% are considerably more expensive than loans attracting a declining balance interest rate of 15%. However, in most cases each loan is described as attracting 15% interest.

> *"Customers in our market have become quite sophisticated and flat rates regardless of the actual rate being charged are perceived as being expensive and unfair. On the products we are developing we are moving to a declining interest rate".*
>
> Ugandan MFI leader

Some institutions can become quite creative at least one African MFI calculates interest rates on its loans according to a formula, which they describe slightly confusingly as *annual declining balance*. This formula calculates the interest payable for each year on a flat rate basis. For longer-term loans the institution recalculates the interest payable every year on a flat rate on the reduced principle outstanding.

Pricing for risk: Financial institutions price loans taking into account their perception of the risk of the loan. Therefore, loans secured on property, or salaries are priced lower than loans secured against collateral substitutes and cash flow assessments. Often institutions providing individual loans to the microfinance sector include an appraisal and monitoring fee in addition to the interest rate on the loan. This covers the more extensive appraisal performed to reduce credit risk. The appraisal fee is usually collected prior to loan appraisal and the monitoring fee at the time of disbursing the loan. In theory this appraisal fee should be related to the cost of performing an appraisal, in practice, however, it is usually a flat charge or percentage charge regardless of the actual expenses incurred.

There are few countries where credit bureaux are active and accessible to institutions serving the low-income market. However, in more developed financial markets the existence of credit bureaux have enabled consumers to access credit at a price that reflects their credit worthiness.

Even within an institution with excellent information it is possible to offer much more carefully tailored terms to customers to reflect the inherent risk in each loan. Credit Indemnity in South Africa divide their customers into ten different categories, 9 categories are a reflection of risk based on performance and the tenth category is for a new customer. Using an Activity Based Costing System, Credit Indemnity was able to see not only the revenue from each category of loans, but also estimate the cost. This information in turn could be used to differentiate prices between customers.

> *"In the last year to 18 months, we've introduced risk-based pricing, so the better you perform as a customer, the longer the loan term and the lower the interest rate you are going to get, as well as a bigger loan should you wish to apply for this. This is an incentive to the customers. For example, our entry-level loan is a 4-month loan at 11.75% per month. It's a very expensive loan. But that's for the entry-level guys. Once they've been on our system for 6 months, they will be allocated a profile and if they have a good profile because they have paid on time, they can become a diamond or platinum client, qualifying for an 18 month loan at 4.25% per month"*
>
> Graham Adie, Credit Indemnity, speaking in Conversations with the Practitioners (Winship, 2006)

Pricing for reward: Often financial institutions reward regular customers who have repaid loans successfully, either through reduced interest rates, or through the cancellation of future appraisal or monitoring fees. Centenary Bank in Uganda have a system whereby after three successful loans, the monitoring fee is no longer charged. This feature is marketed as obtaining an automatic entitlement to credit. Other programmes such as FINCA Tanzania uses pricing as a direct reward, those customers that repay loans on time qualify for an interest rebate.

Joint products: Many microfinance institutions operate group based loan products, which insist on compulsory savings deposits. Compulsory savings significantly increase the cost of the loan to the client, and are universally unpopular, often because microfinance institutions use this money to cover loan default without informing customers. This institutional behaviour is frequently quoted in market research as a reason for the reluctance of clients to hold voluntary savings deposits with the microfinance programme.

Graduation to individual lending: Many institutions graduate selected successful clients to new individual loan products. This is done in an attempt to meet the demands of excellent customers whose needs for credit have grown. In most cases these loans move to being to being secured on assets and collateral, and are priced at a much lower rate than group based loans. This change is usually motivated by a desire to retain successful clients and as a visible incentive to existing group-based customers.

Pricing Electronic Banking Products

Pricing complex products, such as Electronic Banking services is particularly challenging. This is due to a range of overlapping factors, which include the difficulty in setting realistic assumptions during the pilot test period; the absence of existing benchmark prices and the need to move to a volume rather than value based pricing model.

Setting assumptions: Aside from simply adding ATMs to an existing branch infrastructure, electronic banking products, such as mobile phone banking are designed around a complex delivery channel, where costs and revenues are uncertain. Factors driving this uncertainty include the wide range of partners in an electronic banking initiative, the difficulty in assessing the extent of take up of different aspects of the solution and the uncertain cost of extending the system geographically. These assumptions are explored in detail in Electronic Banking for the Poor – Panacea, Potential and Pitfalls, Cracknell (2004).

Absence of benchmark prices: A third challenge to pricing electronic products is the absence in most cases of established benchmarks. How much will poor people pay to be able to transfer value over a mobile phone? How much can be charged for retail transactions which if using cash are perceived as free to the purchaser? How much does someone value making a transaction locally verses travelling in to their nearest town to withdraw cash? Some of these questions can be answered through qualitative market research and studying how poorer people currently perform their financial transactions. Ultimately, however, a pilot test is the only mechanism that can demonstrate conclusive evidence of willingness to pay.

Volume based pricing: Credit and debit cards in Western countries operate on a margin basis banks charge the retailer a percentage of the transaction as a fee, as well as charging the customer interest on any outstanding credit balance. However, this basis may not be appropriate when trying to build electronic banking products for poorer people, and when trying to rollout a network of sales points. This is because it is highly unattractive for retailers to be charged a fee for card-based sales when the system in its early years is unlikely to be heavily used. In addition transactions for the low-income market are likely to be much smaller, making a small transaction based fee a more attractive option.

DEVELOPING PRICING COMPETENCIES

This paper has outlined a simple to understand cost, competition and value based approach to pricing. It has also highlighted the requirement for transparency in pricing. Building on these two key factors, it is possible to suggest a core set of competencies required to perform pricing within a financial institution.

To understand costs and model the impact of changes in price:

i. Detailed knowledge of the management accounts of the institution
ii. An ability to perform allocation and/or activity based costing
iii. Technical knowledge on calculation of interest rates
iv. An ability to perform financial modelling

To understand the pricing charged by competition and to research the perceived value of particular products and services:

v. Skills in qualitative market research, in order to produce a competition analysis matrix, to research customer preferences on pricing and to ascertain how best to explain prices to customers.

To communicate prices transparently:

vi. Communication and marketing skills to produce price related communication materials.

These core competencies are unlikely to be found within a single line-function or department. Pricing is therefore, a collaborative effort, largely between finance and marketing, senior management and the Board of Directors.

IN CONCLUSION

Pricing a financial service is both an art and a science. The “art” of pricing is in choosing a combination of fees and charges acceptable to customers, that are fair and transparent, and in determining if the product has any unique attributes that deserve premium pricing. The “art” of pricing is in careful and considered communication to and feedback from customers and staff to ensure that pricing messages are appropriately and correctly delivered. The “science” of pricing is in ensuring that the product is profitable and is competitive in the market, that aside from very few specific and chosen loss leaders, that each products returns a profit.

In concept product pricing is simple, firstly, establish cost, secondly examine the fees charged by the competition and finally determine whether the product or service has sufficient customer value to deserve a premium price. In practice, pricing is complex, customers and institutions alike find it difficult to track prices regularly and to understand the nuances of pricing calculations. There is a role for regulators in promoting transparency, but a less clear role in setting interest rate ceilings as these can act to restrict the supply of credit. Finally, where possible, pricing should reflect levels of risk and not be an avenue for excessive returns or to cover for inefficiencies in delivery of services.

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