

# Microcredit lending: Small loans; big payback

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Some people may have been surprised when the Nobel Committee awarded the 2006 Peace Prize to Bangladeshi banker Muhammad Yunus. But if ending poverty promotes peace — and there is little disagreement on that point — then Yunus surely merits the honour.

The Grameen Bank he founded is generally credited with being the most successful "microcredit" lender in the world, building an organization that's spawned similar projects in many other countries. While some microcredit operations were around before Grameen Bank's, it is the Bangladesh effort that is now acknowledged to be the most influential.

## What is microcredit?

The Microcredit Summit of 1997 defined microcredit as any program that extends small loans to very poor people for self-employment projects that generate income. Definitions of what constitutes a "small loan" may vary from one country to the next, but many of the loans are as small as the equivalent of \$30. Most loans are under \$200.

A typical loan might see a woman borrow \$50 to buy chickens. The chickens would produce eggs and, eventually, more chickens — all of which she could sell in the market-place.

Every week, she and other local loan recipients will gather to make loan payments — tiny weekly installments that makes repayment much easier for the borrower. The clients also share success stories. Peer support is an integral part of the microfinance system. The loan will be



Muhammad Yunus celebrates in Dhaka, Bangladesh, after winning the Nobel Peace Prize. (Pavel Rahman/Associated Press)

fully repaid in six to 12 months and the money will then be re-lent to someone else in the community.

The loans are usually fronted by non-profit groups that are typically owned by the borrowers themselves. One becomes an owner simply by borrowing. The loans granted by microfinance institutions (MFIs) usually carry an annual interest rate of 15 to 35 per cent (although some loans are interest-free). That may seem high to Western borrowers, but it reflects the high costs they face in running their programs and meeting every week with their clients in the clients' home villages. For most of the borrowers, the only alternative to a microloan is the local moneylender and interest rates that can quadruple the cost of a loan in just one year.

MFIs also don't just loan money. They also offer entrepreneurship and life-skills training, such as literacy and nutrition counselling.

### What are the lending criteria?

The typical recipient of a microloan is very poor. They struggle to survive every day, often living on less than the equivalent of \$1 US a day.

Unlike other types of loans, microcredit loans never require collateral. Being desperately poor is all it takes to qualify. Formal contracts are usually not drawn up. The loans are based on the premise that credit is a human right and that everyone has skills that can be harnessed. Even beggars can get loans.

"Conventional banks look at what has already been acquired by a person," Yunus wrote. "Grameen looks at the potential that is waiting to be unleashed."

It is a refreshingly optimistic vision of humanity.

While not a strict requirement, the reality is that most of the loan programs are targeted to women. The Microcredit Summit Campaign says it's found that women are more likely to repay their loans in full and are more likely to use the money to improve their families' lives. They are, in the words of the Grameen Bank, "the best poverty fighters."

### How effective has microlending been?

In 1997, delegates from 137 countries gathered at the Microcredit Summit in Washington to launch an ambitious campaign goal — to provide microloans to 100 million of the world's poorest families by the end of 2005.

A 2005 progress report noted that more than 66 million poor families had been helped as of the end of 2004, representing more than 330 million people. The summit campaign believes the 100-million goal will be reached by the end of 2006 or 2007.

Microcredit lending is now carried out by more than 3,200 organizations in dozens

of countries in Africa, Asia, and Latin America. The longest-running microlending enterprise — that of Grameen Bank — has loaned \$6 billion US to 6.6 million borrowers in more than 71,000 Bangladeshi villages since 1976 (96 per cent of the clients are women).

Microlending programs report very high repayment rates — usually in excess of 95 per cent. Many of the programs are entirely self-financing. A 2002 Wall Street Journal story said the Grameen Bank was in financial difficulty, but Yunus denied that, saying the bank was in its "strongest position ever." In 2005, Grameen Bank reportedly made a profit of more than \$15 million US.

Microloan projects are also offered in several big American inner cities. Bill and Hillary Clinton said the Grameen Bank project served as a model for microlending activities in some of Arkansas' poorest communities.

Microcredit has its critics — those who say the programs often fail to reach the poorest of the poor, or lead to gender conflict, or charge interest rates that are too high. And its supporters acknowledge that microcredit is no panacea.

In the Nobel Committee's citation, it noted that Grameen Bank and its founder want to eventually eliminate world poverty. "That vision cannot be realized by means of microcredit alone," the citation read.

"But Muhammad Yunus and Grameen Bank have shown that, in the continuing efforts to achieve it [the end of poverty], microcredit must play a major part."

*Retrieved from:*

<http://www.cbc.ca/news/background/economy/microcredit.html>

# Micro-finance Misses its Mark

By Aneel Karnani | *Stanford Social  
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MICROCREDIT IS THE NEWEST silver bullet for alleviating poverty. Wealthy philanthropists such as financier George Soros and eBay co-founder Pierre Omidyar are pledging hundreds of millions of dollars to the microcredit movement. Global commercial banks, such as Citigroup Inc. and Deutsche Bank AG, are establishing microfinance funds. Even people with just a few dollars to spare are going to microcredit Web sites and, with a click of the mouse, lending money to rice farmers in Ecuador and auto mechanics in Togo.

Yet my analysis of the macroeconomic data suggests that although microcredit yields some noneconomic benefits, it does not significantly alleviate poverty. Indeed, in some instances microcredit makes life at the bottom of the pyramid worse. Contrary to the hype about microcredit, the best way to eradicate poverty is to create jobs and to increase worker productivity.

## Microcredit 101

The microfinance movement addresses a basic yet devastating glitch in the formal banking system: Poor households cannot get capital from traditional banks because they do not have collateral to secure loans, and traditional banks do not want to take on the risks and costs of making small, uncollateralized loans. Without this capital, impoverished people cannot rise above subsistence. For example, a seamstress cannot buy the sewing machine that would allow her to sew more clothes than she could by hand, and thereby pull herself out of poverty.

Micro-financiers use innovative contractual practices and organizational forms to reduce the risks and costs of making loans, such as lending to groups, rather than just to one person. Some microcredit organizations give their clients more than loans, offering education, training, healthcare, and other social services. Typically, these organizations are not-for-profit or are owned by customers or investors who are more concerned about the economic and social development of the poor than they are with profits. The largest of these social purpose micro-financiers include Opportunity International, Finca International, Accion International, Oikocredit, and Grameen Bank.

Another innovation that many nonprofit microfinance organizations have adopted is targeting women. At Grameen Bank, for example, 97 percent of clients are women because “women have longer vision [and] want to change their lives much more intensively,” says Yunus. On the other hand, “men are more callous with money.” Evidence indeed suggests that when women retain control of microloans, they spend more on the health, security, and welfare of their families.

## Failures of Microfinance

Despite the hoopla surrounding microcredit, few have studied its impact. One of the most comprehensive studies reaches a surprising conclusion: Microloans are more beneficial to borrowers living above the poverty line than to borrowers living below the poverty line. This is because clients with more income are willing to take the risks, such as investing in new technologies that will most likely increase income flows. Poor borrowers, on the other hand, tend to take out conservative loans that protect their subsistence, and rarely invest in new technology, fixed capital, or the hiring of labor.

Microloans sometimes even reduce cash flow to the poorest of the poor, observes Vijay Mahajan, the chief executive of Basix, an Indian rural finance institution. He concludes that microcredit "seems to do more harm than good to the poorest." One reason could be the high interest rates charged by micro-credit organizations. Aceda, a Cambodian commercial bank specializing in microcredit, charges interest rates of about 2 percent to 4.5 percent each month. Some other micro-lenders charge more, pushing most annual rates to between 30 percent and 60 percent. Microcredit proponents argue that these rates, although high, are still well below those charged by informal moneylenders. But if poor clients cannot earn a greater return on their investment than the interest they must pay, they will become poorer as a result of microcredit, not wealthier.

Another problem with microcredit is the businesses it is intended to fund. A microcredit client is an entrepreneur in the literal sense: She raises the capital, manages the business, and takes home the earnings. But the "entrepreneurs" who have become heroes in the developed world are usually visionaries who convert new ideas into successful business models. Although some microcredit clients have created visionary businesses, the vast majority are caught in subsistence activities. They usually have no specialized skills, and so must compete with all the other self-employed poor people in entry-level trades. Most have no paid staff, own few assets, and operate at too small a scale to achieve efficiencies, and so make very meager earnings. In other words, most microenterprises are small and many fail – contrary to the United Nations' hype that micro-entrepreneurs will grow thriving businesses that lead to flourishing economies. This should not be too surprising. Most people do not have the skills, vision,

creativity, and persistence to be entrepreneurial. Even in developed countries with high levels of education and access to financial services, about 90 percent of the labor force is employees, not entrepreneurs.

The reality of microcredit is less attractive than the promise. Even a stalwart proponent of neoliberal policies like *The Economist* is beginning to conclude that "the few studies that have been done suggest that small loans are beneficial, but not dramatically so."

### **Jobs, Not Microcredit**

Microcredit is certainly a noble idea and a genuine innovation that has provided some positive impact to its clients, particularly to women's noneconomic empowerment. It also helps the poor during cyclical or unexpected crises, and thus reduces their vulnerability. But the critical issue is whether micro-credit helps eradicate poverty. And on that front, it falls short.

China, Vietnam, and South Korea have significantly reduced poverty in recent years with little microfinance activity. On the other hand, Bangladesh, Bolivia, and Indonesia haven't been as successful at reducing poverty despite the influx of microcredit.

Consider the patterns of poverty and employment over time in China, India, and Africa, whose populations make up about three-quarters of the world's poor. Each region has pursued a different path to economic development, and the results so far have been markedly different.

In China, a large and growing percentage of the population is employed in a job. At the same time, the percentage of people living in poverty has declined significantly in recent decades. In Africa, a small and shrinking fraction of the population is employed, and the incidence of poverty has remained

unchanged during the same period. India's performance lies somewhere between the two: The number of people in jobs has grown some, and the number of people in poverty has shrunk a little.

### **The State's Responsibilities**

Poverty alleviation cannot be defined only in economic terms; it is also about addressing a much broader set of needs. Amartya Sen, the Nobel Prize-winning economist, eloquently argues that development can be seen as a "process of expanding the real freedoms that people enjoy." Social, cultural, and political freedoms are desirable in and of themselves, and they also enable individual income growth. Services such as public safety, basic education, public health, and infrastructure nurture these freedoms and increase the productivity and employability of the poor, and thus their income and wellbeing.

Overall, governments, businesses, and civil society would be well advised to reallocate their resources and energies away from micro-finance and into supporting larger enterprises in labor-intensive industries. This is what is alleviating poverty in China, Korea, Taiwan, and other developing countries. At the same time, they should also provide basic services that improve the employability and productivity of the poor. Otherwise, they will miss the mark of lifting people out of poverty.

° Retrieved from  
[http://www.ssireview.org/articles/entry/microfinance\\_misses\\_its\\_mark](http://www.ssireview.org/articles/entry/microfinance_misses_its_mark)



# Sacrificing Microcredit for Megaprofits

By Muhammad Yunus

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In the 1970s, when I began working here on what would eventually be called “microcredit,” one of my goals was to eliminate the presence of loan sharks who grow rich by preying on the poor. In 1983, I founded Grameen Bank to provide small loans that people, especially poor women, could use to bring themselves out of poverty. At that time, I never imagined that one day microcredit would give rise to its own breed of loan sharks. But it has. And as a result, many borrowers in India have been defaulting on their microloans, which could then result in lenders being driven out of business. India’s crisis points to a clear need to get microcredit back on track.

Troubles with microcredit began around 2005, when many lenders started looking for ways to make a profit on the loans by shifting from their status as nonprofit organizations to commercial enterprises. In 2007, Compartamos, a Mexican bank, became Latin America’s first microcredit bank to go public. And this past August, SKS Microfinance, the largest bank of its kind in India, raised \$358 million in an initial public offering. To ensure that the small loans would be profitable for their shareholders, such banks needed to raise interest rates and engage in aggressive marketing and loan collection. The kind of empathy that had once been shown toward borrowers when the lenders were nonprofits disappeared. The people whom microcredit was supposed to help were being harmed. In India, borrowers came to believe lenders were taking advantage of them, and stopped repaying their loans.

Commercialization has been a terrible wrong turn for microfinance, and it indicates a worrying “mission drift” in the motivation of those lending to the poor. Poverty should be eradicated, not seen as a money-making opportunity. There are serious practical problems with treating microcredit as an ordinary profit-maximizing business. Instead of creating wholesale funds dedicated to lending money to microfinance institutions, as Bangladesh has done, these commercial organizations raise larger sums in volatile international financial markets, and then transmit financial risks to the poor. Furthermore, it means commercial microcredit institutions are subject to demands for ever-increasing profits, which can only come in the form of higher interest rates charged to the poor, defeating the very purpose of the loans.

Some advocates of commercialization say it’s the only way to attract the money that’s needed to expand the availability of microcredit and to “liberate” the system from dependence on foundations and other charitable donors. But it is possible to harness investment in microcredit — and even make a profit — without working through either charities or global financial markets.

Grameen Bank, where I am managing director, has 2,500 branches in Bangladesh. It lends out more than \$100 million a month, from loans of less than \$10 for beggars in our “Struggling Members” program, to micro-enterprise loans of about \$1,000. Most branches are financially self-reliant, dependent only on deposits from ordinary Bangladeshis.

When borrowers join the bank, they open a savings account. All borrowers have savings accounts at the bank, many with balances larger than their loans. And every year, the bank's profits are returned to the borrowers — 97 percent of them poor women — in the form of dividends.

More microcredit institutions should adopt this model. The community needs to reaffirm the original definition of microcredit, abandon commercialization, and turn back to serving the poor. Stricter government regulation could help. The maximum interest rate should not exceed the cost of the fund — meaning the cost that is incurred by the bank to procure the money to lend — plus 15 percent of the fund. That 15 percent goes to cover operational costs and contribute to profit. In the case of Grameen Bank, the cost of fund is 10 percent. So, the maximum interest rate could be 25 percent.

However, we charge 20 percent to the borrowers. The ideal “spread” between the cost of the fund and the lending rate should be close to 10 percent. To enforce such a cap, every country where microloans are made needs a microcredit regulatory authority. Bangladesh, which has the most microcredit borrowers per square mile in the world, has had such an authority for several years, and it is devoted to ensuring transparency in lending and prevented excessive interest rates and collection practices. In the future, it may be able to accredit microfinance banks. India, with its burgeoning microcredit sector, is most in need of a similar agency.

There are always people eager to take advantage of the vulnerable. But credit programs that seek to profit from the suffering of the poor should not be described as “microcredit,” and investors who own such programs should not be allowed to benefit from the trust and respect that microcredit banks have rightly earned. Governments are

responsible for preventing such abuse. In 1997, then First Lady Hillary Clinton and Prime Minister Sheikh Hasina of Bangladesh met with other world leaders to commit to providing 100 million poor people with microloans and other financial services by 2005. At the time, it looked like an utterly impossible task, but by 2006 we had achieved it. World leaders should come together again to provide the powerful and visionary leadership to help steer microcredit back on course.

*Muhammad Yunus, the founder of Grameen Bank, received the Nobel Peace Prize in 2006.*

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