

Making Microlending Work

By Dr. Linda Eagle

Twice a month, Rose Anite, a 26 year old Sudanese woman, buys fish from a location near the Nile River in Uganda. Rose then sells the fish at the open market in the Sudanese city of Yea. However, due to poor roads and a crumbling infrastructure, Rose's trips to Uganda last a long and wearisome seven days. In order to improve her business and her quality of life, Rose joined SUMI, the Sudan Microfinance Institution. From SUMI, Rose took out a loan equivalent to \$100—a large sum considering Rose started her business with the mere equivalent of \$75. With the money from her loan, Rose is able to buy fish in larger quantities – allowing her to make more from each trip. Even this small increase in profits has made a significant difference to her quality of life.

The extension of small loans or microloans to the poor, such as Rose, who do not have access to traditional financial services due to lack of collateral, employment, and credit history is known as microlending, or microcredit. Microlending is a division of microfinance—the provision of financial services to those living in extreme poverty—and is a booming phenomenon that shows great promise in alleviating the condition of the poor in developing nations and being a viable channel for profits for financial institutions.

The History of Microlending

Although microlending is a recent phenomenon, its origin dates back centuries. One of the earliest microlending organizations was the Irish Loan Fund system founded in the early 1700s by the Irish author and essayist Jonathan Swift. In order to help alleviate poverty, the Irish Loan Fund system provided credit without collateral to the poor.

The modern microlending revolution did not occur until the 1970s. One of the first pioneers was Accion International. Accion International began as a student-run volunteer organization that sought to relieve poverty in Latin America through construction and infrastructure projects but turned their efforts toward microfinance. In 1973, Accion offered some of the first modern microloans to the poor in Recife, Brazil seeking to establish small businesses. Accion's experiment proved to be a success; within four years, they had provided 885 loans with a repayment rate higher than 90%. Additionally, the loans helped the creation and stabilization of 1,386 new jobs.

Perhaps the most important and successful pioneer in microlending is Muhammad Yunus, a Bangladeshi economist and economics professor. In 1974, famine struck Yunus' native country and Yunus became involved in poverty reduction. Yunus determined that small loans were capable of greatly alleviating the condition of the poor. In 1976, he founded the Grameen Bank in Bangladesh, the world's largest and most successful microfinance institution or MFI. Since its inception, Grameen has provided more than \$5 billion in loans to several million borrowers and boasts a repayment rate as high as 98%. Last year, the institution made a profit of \$20 million. Most importantly, Grameen Bank has laid forth the business model for most other modern microfinance institutions.

Making Microlending Work

The central principle of microlending is lending to the poor without collateral. Microlending is based upon the belief that the poor's desire to better their conditions will make them successful

entrepreneurs capable of paying off their loans. These loans are not to be treated as charity; they are expected to be paid off and carry interest. While this is the central principle, the following are several other strategies typical of the microlending model:

1. Lend to small groups of people.

Joint liability alleviates the need for collateral because several members of a group are more likely to manage a debt than an individual. Lending to groups reduces the need for an institution to monitor the borrowers because each member of the group has a vested interest in paying off the loan and will monitor the other members. Additionally, groups are more likely to fund successful projects because group members may provide advice to each other to solve business problems.

2. Lend to women.

Most microlending institutions lend almost exclusively to women. Global microlending experience has shown that women are more likely to repay their loans than men and although men are more likely to spend loans on themselves, women are more likely to fund the improvement of their businesses.

3. Utilize a graduated loan policy.

Because borrowers lack a credit history from which an institution may evaluate the risk of default, a graduated loan policy is required. Borrowers begin with small loans. Upon repayment, borrowers qualify for greater loans that can be taken out for longer periods of time.

4. Charge high interest rates.

Typical annual interest rates range from 20% to 50%. High interest rates are necessary due to smaller loan sizes, higher risk of borrower default and labor intensive collection due to borrowers residing in rural areas.

5. Focus on Managing Productivity and Quality.

The key to a profitable microlending channel is efficiency in banking operations. Loan origination, processing and collections must be streamlined and tightly managed with efficient capacity planning, forecasting and scheduling. With such small loan amounts and high volume, institutions cannot afford any waste that will erode the bottom line.

Humanitarian Implications

In addition to ensuring economic viability, several aspects of the microlending business model have humanitarian implications. The central principle of microlending to the poor is to offer borrowers an exit from poverty. However loans, as opposed to charitable donations, ensure that borrowers also learn financial skills necessary for success as it provides them with a foundation for establishing a credit history.

Today

The international community has recently acknowledged the promise and impact of microlending. The United Nations declared 2005 the International Year of Microcredit. In 2006, the Norwegian Nobel Committee awarded the Nobel Peace Prize to both Muhammad Yunus and the Grameen Bank "for their efforts to create economic and social development from below" through the use of microlending.

According to estimates by the World Bank, there are more than 7,000 microfinance institutions serving 20 million people in developing nations. The CGAP, the Consultative Group to Assist the Poor, estimates that 500 million households have benefitted from microloans. While the majority of these programs exist in the developing nations of Asia and Latin America, microlending is now present in more advanced economies such as the United States, England and Norway. A 2005 study by the Aspen Institute, an international nonprofit organization committed to the study of global issues, concluded that there are 246 lenders in the United States who made 13,231 loans amounting to \$114 million.

On the Web

In October of 2005, microlending hit the web. Kiva.org was the first website to allow users to extend microloans to entrepreneurs in developing nations. Lenders choose a business to sponsor listed on the website and make loans using their credit cards. The funds are transferred to Kiva's local partnered microfinance institutions which then give the money to borrowers and collect repayments that are returned to the lender.

In October of 2007, eBay launched MicroPlace.com. Unlike Kiva.org, loans at MicroPlace.com are securitized and lenders will earn interest.

The Future of Microlending

The Grameen Bank and Accion International have been very successful. However, not all microfinance institutions have succeeded and some experts have expressed doubts over the economic viability of microlending and the sustainability of microfinance institutions. In fact, Grameen Bank relied on subsidies in its initial development before it became self-sustainable and the Wall Street Journal has questioned its repayment rates. Nonetheless, Grameen Bank's profits continue to grow each year and half of its borrowers have emerged from acute poverty as measured by such standards as their ability to pay for their children's schooling, provide 3 meals a day to the members of their household, acquire rainproof shelter, etc. Microfinance, in some circumstances, has proven to hold great promise in relieving poverty while remaining a profitable venture.

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