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Sacrificing Microcredit for Megaprofits

By MUHAMMAD YUNUS JAN. 14, 2011

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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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