**Microfinancing Notes**

**What is microcredit?**

Microcredit is a small amount of money loaned to a client by a bank or other institution. Microcredit can be offered, often without collateral, to an individual or through group lending.

• Group lending, also known as solidarity lending, is a mechanism that allows a number of individuals to provide collateral or guarantee a loan through a group repayment pledge. The incentive to repay is based on peer pressure; if one person in the group defaults, the other group members make up the payment amount.

• Individual lending, in contrast, focuses on one client and does not require other people to provide collateral or guarantee a loan.

What is microfinance?

• Microfinance refers to loans, savings, insurance, transfer services and other financial products targeted at low-income clients. Microcredit, then, is one component within the broader spectrum of microfinance.

Source: www.yearofmicrocredit.org

**Why is microfinance necessary?**

If you want to buy something or start a business but do not have the money you might try and save the money, sell or pawn something you own, or borrow the money from family, bank or lending institution. To save money assumes you have a way of earning it and there is somewhere safe to keep it. To borrow money from family assumes they have it and are able to do without it until you are able to pay it back. To borrow money from a bank, credit union or other lending institution assumes you can demonstrate an ability to pay it back. Lending institutions will not lend to people unless they have some kind of security, or collateral, for the loan, to ensure that if it is not paid back, the bank or other institution will be able to recover part of the debt. Poor people often do not have spare money to lend other family members, access to banks or the collateral to guarantee a loan, so they find it difficult to try to improve their situation through loans. Yet a very small loan can make a great difference to a poor person.

Microcredit is helping millions of poor people, especially poor rural women, with tiny loans so they can start small, create self-employment and improve their lives. There is a common view that poor people cannot or do not want to save. But the reality is different. Because the poor have little money, making the most of what they do have is vital. Building a pool of savings that can be drawn on in emergencies, or that can help to finance the education of children or the purchase of a productive asset, is vital to poor households, and providing them with safe and accessible means of doing this is therefore an important service.

Poor households are particularly vulnerable to the setbacks that come from ill health, loss of employment and other emergencies. Providing insurance that can mitigate the impact of such setbacks is another vital financial service. While insurance is a very different business from taking deposits and making loans, a number of microfinance organizations are looking at including insurance services in their range of products.

**The beginnings of microfinance**

The idea of microfinance was developed as a survival strategy for the poor. Ela Bhatt established the Self-Employed Women's Association (SEWA) in India in 1974, while in 1976 Mohammed Yunus founded the Grameen Bank project in Bangladesh. Ela Bhatt's first loan was $1.50 to a woman who sold herbs, while Mohammed Yunus' initial outlay was a total of $27 to forty-two poor people.

**How microfinance works**

Poor people often live from day to day, and have few reserves for major expenses such as illness, weddings, house repairs or education. They are often unable to save for these expenses, or have been unable to open a bank account that would enable them to build their savings, and therefore need to borrow, frequently at exorbitant rates, to meet these unexpected costs, further worsening their economic situation. Microcredit provides poor people with access to small loans at more manageable interest rates, and can lead to self-sufficiency and poverty alleviation. There are many models of microcredit. A common model is for small groups to form a collective and with a start up grant to provide an initial pool of money, which is augmented with regular savings and interest members pay on their small loans. One or two members take loans to develop small businesses, and, when they have repaid their loan, others are able to draw on the collective fund. They may be supported with business and other training to help make these micro-enterprises successful. The outside support and group pressure leads to a low default on repayments.

Where poor people are able to build their savings, they can often use these savings to meet their needs for lump sums of money, either to meet emergencies or to finance a productive investment. This is less risky than relying on credit, because it doesn't involve going into debt. Saving and borrowing are really different ways of turning small amounts of money into lump sums. Saving involves building a lump sum by first accumulating smaller amounts; borrower is taking the lump sum first and then 'saving' afterwards in the form of loan repayments.

**How does microfinance address poverty?**

With less interest to repay, more profitable businesses and autonomy, poor people have been able to reduce debt burdens and break the cycle of poverty. Studies of the impact of microfinance in more than 24 countries have found dramatic improvements in household income levels. These improvements take place mainly through growth in the borrower's business. Access to microfinance allows the borrower to reduce costs with lower interest rates and bulk purchasing of raw materials. Income increases as the number of goods or services offered is expanded and reduced product costs increase sales.

**Is it all good news?**

Although microfinance can demonstrate huge levels of success, there are risks and other disadvantages to the scheme. Maintaining a sustainable small loans program is costly, and the high interest rates take their toll on borrowers, although less than that of local money-lenders who may charge even higher interest rates or indenture children.   
  
Microfinance fosters self-employment, but the odds are stacked against the self-employed in the global marketplace. Business training and support can be important so that loans can be effectively used. However, many poor entrepreneurs in fact know very well what to do, but lack the capital needed to set up or expand their businesses.

While women have taken a high percentage of the loans and invested in their households, improving the health and education of their children, this has had a cost. Running a business has added to their workload and changed their role in the family, sometimes putting a strain on their marriage. Moreover, in some cases husbands have used the loans, but expected the women to repay it. It is important to include gender training as part of the microfinance program to address these problems.

Microfinance programs may enable poor people to improve their situation, but they do not eliminate the need for other basic social and infrastructure services. Microfinance can help poor households to reduce their vulnerability to economic shocks, but they do not eliminate such shocks. It helps the poor to take advantage of economic opportunities, but it does not create such opportunities. Microfinance can only ever be one part of a broader process of social and economic development.

*Source:*

Global Education Project:

http://www.globaleducation.edna.edu.au/globaled/go/cache/offonce/pid /1533;jsessionid=0BDB10DB1465E68326A0997A1D98864F