

Forum: The Second General Assembly

Issue: The question of the implementation of microcredit systems

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Introduction

Introduced in the 1970s, microfinance promised to “combat poverty and to develop the institutional capacity of financial systems through finding ways to cost-effectively lend money to poor households”. Most microfinancing operations occur in underdeveloped countries such as Uganda, Bangladesh, Indonesia, Honduras, and Serbia. Microfinance lenders, like ordinary creditors, charge interest on loans and have specific repayment plans which make it easier for the debtors to pay them back.

A famine destroyed the country of Bangladesh in 1974, which led Muhammad Yunus, an economics professor, to alter his economic theories to apply to those who need it most, the poor. It started with a group of women borrowing US\$27 to purchase materials for their business. The women were not only able to repay the microcredit loan but to also sustain their businesses. Muhammad Yunus later went on to develop the Grameen Bank, which today is one of the largest microfinance institutions with a loan portfolio of US\$25 billion, a repayment rate of 98%, and serving over 100 million people. Following Yunus’ example in Bangladesh, microfinance began as various experiments in Latin America and South Asia and has now spread globally to Africa, Latin America, Asia, and Eastern Europe, as well as richer economies such as the United States, Norway, and England. By 1999, microfinance has reached five continents and was benefitting 2.5 million people.

Many of the applicants are unable to offer collateral, which leads to microlenders often pooling borrowers together as a buffer. After receiving loans, recipients repay their debts together. The success of the program depends on everyone's contributions, so this creates a form of peer pressure that helps ensure repayment. Doing this helps all group members start and develop a good credit history. The goal of microfinance in the modern-day is to lend to the underprivileged as well as generate profit for MFIs/MCIs (microfinance/microcredit institutions). Microfinance intends to do all this while avoiding corruption and dependence on subsidization. Many economists have called it completely idealistic, however, it has been tried and deemed plausible as seen by its global adaptation.

The Grameen Bank has introduced many innovations which are now considered the cornerstone of new programs and initiatives in the microfinance sector. Two of these are group lending and focusing on female customers. Group lending allows the group to distribute themselves into risky and safe borrowers. This occurs mostly because if someone is unable to make their payment, the rest of the group must find the means to assist him/her. If they fail to do this, their credit is immediately terminated. This pushes borrowers to repay their loans since one person defaulting on their payment affects the whole group. There are 2 main reasons for targeting the female demographic; first, females are known to be more conservative with their investments. This ensures the return on investment will enable them to pay their loans back. The second reason is that catering primarily to women will help in meeting social objectives. It will help women have the same opportunities, in terms of finance, as men and grant them access to generate profits by starting self-owned businesses, reducing the gender pay gap. In 2004, women made up more than 84% of the clients of the world's 34 largest MCIs.

The Microcredit Summit Campaign was held on 2-4 February 1997 in Washington D.C. It set a goal of reaching 100 million of the world's poorest families in the next 10 years. The Summit Campaign managed to gain worldwide support and the backing of

numerous foundations and world leaders. The Millennium Development Goals has heavily supported the microfinance program and the United Nations recognized 2005 as the year of Micro-Credit.

Microfinance has the potential to reduce income inequality and poverty by a lot, but it has a few disadvantages. Firstly, it puts too much pressure on the debtor to repay the loans since it is the entire group's responsibility to pay it back, this in many cases creates peer-pressure and social stigma between the group members since they are often neighbors, friends, and family. This increased pressure leads to a large suicide rate among borrowers because of the severe debt levels. Secondly, as the MFIs have a profit objective, they charge extremely high interest rates which are often upwards of 30%. This takes advantage of the borrowers since it creates a debt-trap for them, increasing the income for the MFI since interest adds up over time.

Definition of Key Terms

Microfinance

Financial services provided to unemployed or low-income individuals or groups who lack access to conventional banking services.

Microcredit

Microcredit is a form of microfinance, a very small loan given to a person to become self-employed or start and grow a small business. These debtors are typically low-income individuals, especially from Less Economically Developed Countries (LEDCs). Microcredit is also referred to as "microlending" or "microloan".

Credit history

A credit history is a record of a borrower's responsible repayment of debts. A better credit history will lead to a higher credit score, enabling the borrower to borrow larger loans.

MFIs/MCIs

Institutions that provide microfinance and microcredit are known as Microfinance/Microcredit Institutions (MFIs/MCIs).

MEDCs

Countries that have a developed economy are referred to as more economically developed countries (MEDCs).

LEDCs

Countries that do not have a developed economy are referred to as less economically developed countries (LEDCs).

Debtor

A person, country, organization, or entity that owes money.

Creditor

A person, country, organization, or entity that is owed money.

Collateral

Any item of equal value to the loan that is pledged as security for repayment of the loan. The item will be forfeited to the creditor in the event of a default on the payment.

Corruption

People of power in the public sector being dishonest or fraudulent. The most popular case of this is bribery.

Subsidization

The government undertaking partial costs of a business entity so that it can provide welfare goods and services for cheaper, making them widely accessible.

Debt-trap

A debt trap is when a borrower is forced to take out more new loans to pay existing loans, keeping them trapped in a cycle of paying interest and taking on new debts.

Key Issues

Limited amount of MFIs

There are very few successful Microfinance Institutions. This is due to the need for a large amount of capital to start and maintain a money lending agency. This leads to the government subsidizing the startup of such institutions. Because of these reasons, many MFI programs have not been able to reach self-sufficiency, and a few have failed altogether.

The concept of Microfinance is relatively new

Microfinance has only existed in the mainstream finance sector for 40 years. This makes it relatively new which leads it to look unconventional, deterring major banking and finance firms from investing in it.

High interest rates

Microcredit interest rates are extremely high, as much as 30% in many cases. This is due to 2 major reasons. Firstly, the MFI needs to make a profit on the loans handed out. The loans are of small amounts, but the overheads of the MFIs are just as high as other institutions, thus the need for high interest rates.

Risk management issues

. Microcredit loans are extremely risky for the creditor because the debtors are often underprivileged and may not be able to pay it back. Debtors in many cases do not even have the resources to provide collateral. This creates a huge pressure on the borrowers to pay loans back and steers away potential creditors looking to start MFIs. The high pressure on the borrowers also leads to high suicide rates among them.

Major Parties Involved and Their Views

Bangladesh

Microfinance was founded in Bangladesh, so it has had an immense effect there. Grameen bank, which is the first-ever MFI was started in Bangladesh and now is one of the largest MFIs today. Bangladesh heavily supports the concept of microfinance since the system has helped many underprivileged and poor citizens.

India

Due to India's close geographical proximity to Bangladesh, microfinance in India started at the same time as Bangladesh. The SEWA Bank was the first to introduce microfinance and microcredit commercially. Like Bangladesh, MFIs have helped many Indian citizens, bringing down the poverty rate and empowering women. Despite its strong potential, many rural areas of India do not have access to these services.

United States

Microcredit in the US is classified as loans less than US\$50,000. These are often given to low-income individuals looking to become self-employed and entrepreneurs. Many MFIs in the US offer other services such as financial literacy and business administration courses for extremely cheap prices, and even for free sometimes. This helps the borrowers be financially responsible and contributes to their success. Microfinance has been extremely successful in the US, especially in places such as Brooklyn, Bronx, Manhattan, Queens, New York, Omaha, Nebraska, and Indianapolis.

Development of Issue/Timeline

Date	Event	Outcome
October 1983	Grameen Bank: The first microfinance organization and community development bank founded in Bangladesh.	Grameen Bank is now one of the largest and most influential microfinance institutions.
2-4 February 1997	Microcredit Summit Campaign held in Washington D.C.	Set a goal of reaching 100 million of the world's poorest families in the next 10 years. The Summit Campaign managed to gain worldwide support and the backing of numerous foundations and world leaders.
1999	Countries start to use the Grameen Bank model in experiments worldwide.	Microfinance goes global and is implemented in over 5 continents, benefitting 2.5 million people.
2005	Year of Micro-Credit	The Economic and Social Council of The United Nations recognized 2005 as the year of micro-credit helping spread awareness about it worldwide.

2006	Muhammed Yunus was awarded the Nobel Prize in 2006	Muhammed Yunus, the founder of Grameen Bank and the microfinance system was awarded the Nobel Prize 2006 by the Norwegian Nobel Committee for his efforts to create economic and social development by giving equal opportunities to all genders and income levels.
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Previous Attempts to Solve the Issue

Grameen Bank:

The Grameen Bank was the first MFI that provided loans to the poor. Today Grameen Bank is one of the largest and most influential microfinance institutions in the world with over 2,500 branches worldwide. This MFI has helped reduce poverty, improve schooling levels, and expanded millions of small businesses worldwide.

Possible Solutions

Building more MFIs

There are quite a few MFIs worldwide already but most of them have not been able to reach self-sufficiency. Governments could further subsidize and reduce taxation for the building of MFIs which would encourage private banking institutions to expand into the microfinance sector.

More education and outreach

Governments and existing MFIs could educate citizens on microfinance and microcredit using mass-marketing tools such as flyers, seminars, and workshops. This would increase the outreach of microfinance and increase the potential customers since more people are being made aware of the services.

Use crowdfunding

Governments, NGOs, and MFIs can start online crowdfunding programs which allow citizens worldwide to donate as well as get funding over the internet. This could further be improved by aiding the programs by marketing them using online advertisements, reaching millions of people worldwide.

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