Muhummad Yunus, a recipient of the 2006 Noble Peace Prize believes that credit is a human right. He trusts that anyone who is taught the skills and given the chance to borrow money, can manage their finances and repay their loans successfully. Yunus believes that people can escape the vicious cycle of poverty with credit in the form of microloans. Microcredit and microfinance give people who are otherwise considered “non-bankable” the opportunity to access banking services and financial products. The loans are then used as upfront capital to help create successful entrepreneurs and businesses through producing a sustainable income.

Microfinance is different from traditional banking. Traditional banking requires a form of security such as collateral to prove a borrower’s creditworthiness when obtaining the loan. However, microfinance uses the group method. The group method is essentially peer pressure. One cannot obtain a loan without a support group. First, one person from the group gets the loan and once they have proved their ability to pay it back then the other members of the group can start to obtain loans. In traditional banking, one large sum payment is typically due in a specified amount of time. Microloans are different because they require much more frequent payments of smaller amounts. The smaller amounts make budgeting easier and more manageable for those new to managing finances.

The most controversial aspect of micro lending are the high interest rates that borrowers incur. There are many factors that contribute to the high interest rates associated with micro lending. Some factors are typical to all interest rates; including a base, risk free rate, currency and political risk. However, there is an income premium associated with the interest rates. First, one premium comes from the cost of funds. This means the cost of getting the money before it has been loaned out to an individual. Added to that is a loan loss expense. This acts as a reserve to compensate for other borrower’s losses. On top of that there are operating expenses, including the cost of running the business, such as employee
compensation, overhead costs and firm assets. Finally, a for profit business has a profit premium. This means a portion of the interest rate is profit for the business to grow.

The controversial question is, are microloans business or charity? A business implies making a profit off of goods and services. However, the social mission of microfinance institutions acts as charity. Can businesses ethically profit from people in extreme poverty?